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Status: GRANTED

Title: United States, Petitioner
v.
Goodyear Tire and Rubber Company and Affiliates

Docketed:
March 8, 1989

Court: United States Court of Appeals for the Federal Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Coughlin,Barring

U.S. Court of Claims

Entry	Date	Note	Proceedings and Orders
1	Mar 8 1989	G	Petition for writ of certiorari filed.
2	Apr 5 1989	X	Brief of respondent Goodyear Tire & Rubber Co. in opposition filed.
3	Apr 5 1989		DISTRIBUTED. April 21, 1989
5	Apr 18 1989	X	Reply brief of petitioner United States filed.
6	Apr 24 1989		REDISTRIBUTED. April 28, 1989
7	May 1 1989		Petition GRANTED.
			**
10	Jun 14 1989		Order extending time to file brief of petitioner on the merits until July 6, 1989.
8	Jun 15 1989		Joint appendix filed.
11	Jul 6 1989		Brief of petitioner United States filed.
13	Jul 24 1989		Order extending time to file brief of respondent on the merits until September 5, 1989.
14	Aug 21 1989		Record filed.
		*	certified record, USCA Fed Circuit
18	Aug 28 1989		SET FOR ARGUMENT WEDNESDAY, NOVEMBER 1, 1989. (4TH CASE)
15	Sep 1 1989		Brief of respondent Goodyear filed.
16	Sep 5 1989		Brief amicus curiae of National Foreign Trade Council filed.
17	Sep 5 1989	G	Motion of Vulcan Materials Company for leave to file a brief as amicus curiae filed.
19	Sep 13 1989		CIRCULATED.
20	Oct 2 1989		Motion of Vulcan Materials Company for leave to file a brief as amicus curiae GRANTED.
21	Oct 2 1989	X	Reply brief of petitioner United States filed.
22	Nov 1 1989		ARGUED.

88-1474 (1)

No.

In the Supreme Court of the United States

OCTOBER TERM, 1988

UNITED STATES OF AMERICA, PETITIONER

v.

THE GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTION PRESENTED

Whether the term "accumulated profits" in the foreign tax credit provisions of Section 902 of the Internal Revenue Code means income or profits as defined by the tax law of the United States or, instead, as defined by the tax law of a foreign country.

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No.

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THE GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra,* 1a-8a) is reported at 856 F.2d 170. The opinion of the Claims Court (App., *infra,* 9a-28a) is reported at 14 Cl. Ct. 23.

JURISDICTION

The judgment of the court of appeals (App., *infra,* 29a) was entered on August 31, 1988. A petition for rehearing was denied on November 8, 1988 (App., *infra,* 31a). On January 25, 1989, the Chief Justice extended the time within which to petition for a writ of certiorari to and including March 8, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Sections 316, 901, and 902 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.902-3 of the Treasury Regulations on Income Tax (26 C.F.R.), as in effect for 1970 and 1971, are set forth in pertinent part in a statutory appendix (App., *infra,* 32a-35a).

STATEMENT

1. This case involves the foreign tax credit applicable to the taxation of dividend income received by a domestic corporation from its foreign subsidiary. When a foreign subsidiary delivers all or part of its profits to its parent, that money generally is taxable to the parent as a dividend under the provisions of Sections 301 and 316 of the Internal Revenue Code.[1] If those profits have already been subjected to income tax by the foreign country where they were earned, simple taxation as a dividend by the United States will result in double taxation of the same income. Accordingly, Sections 901(a) and 902(a)(1) of the Code allow the parent (if it owns at least 10% of the voting stock of the foreign subsidiary) to take an "indirect" or "deemed paid" credit against its United States income tax to reflect income tax paid by the subsidiary to a foreign country.

The situation is complicated somewhat when, in a particular year, the foreign subsidiary does not deliver all of its profits to its parent, but instead retains some of the profits and adds them to surplus. In that event, giving the parent a full credit for all of the foreign income tax paid by the subsidiary would be a windfall because the parent is not receiving all of the subsidiary's profits as a dividend

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect during 1970 and 1971, the years at issue (the Code or I.R.C.).

subject to United States income tax. Therefore, the Code allows the parent to take a credit for only a prorated portion of the foreign income taxes paid by the subsidiary. See generally *American Chicle Co.* v. *United States,* 316 U.S. 450 (1942).

Section 902(a)(1) provides for the computation of the allowable credit as follows: "to the extent such dividends are paid by such foreign corporation out of accumulated profits," the parent is "deemed to have paid the same proportion of any income * * * taxes paid * * * by such foreign corporation to any foreign country * * * on or with respect to such accumulated profits, which the amount of such dividends * * * bears to the amount of such accumulated profits in excess of such * * * taxes." In other words, the allowable prorated credit is computed by multiplying the foreign taxes paid by a fraction – the ratio of the dividends paid to the subsidiary's (after-tax) accumulated profits. This computation is illustrated by the following equation (see App., *infra,* 4a, 15a n.6):[2]

$$\text{Foreign taxes paid} \times \frac{\text{Dividends}}{\begin{array}{c}\text{Accumulated profits}\\ \text{minus foreign taxes}\end{array}} = \S\ 902 \text{ credit}$$

The issue in this case is the meaning of the term "accumulated profits" – specifically, whether it refers to the

[2] This Court described this equation in narrative form in *American Chicle,* stating that the foreign taxes are multiplied by a fraction, of which "[t]he numerator is the dividends received by the parent [and] [t]he denominator is the 'accumulated profits' of the subsidiary" (316 U.S. at 452); the statute was later amended to require the subtraction of foreign taxes from the denominator. The operation of the proportional credit can be illustrated by some simple examples. If a foreign subsidiary earns $100 of profits, pays $20 in foreign taxes and distributes the remaining $80 to its parent as a dividend, the parent is entitled to the full $20 credit ($20 × $80/($100 – $20)). If, however, the subsidiary distributes only $40 of its after-tax profits to its parent,

subsidiary's profits as computed under United States tax law or under the tax law of the foreign country.[3]

2. Respondent is an affiliated group of domestic corporations that file consolidated federal income tax returns. The parent of the group (Goodyear U.S.) owns all of the stock of a British subsidiary (Goodyear U.K.) that does not join in the consolidated return. During 1970 and 1971 the subsidiary reported net income on its British tax returns, paid taxes to Britain on that income, and distributed dividends to its parent. On its 1973 British tax

the allowable credit will be halved to $10 ($20 × $40/($100 − $20)). The allowable credit can also be affected by a change in the denominator of the equation. If the subsidiary distributes the same $80, but the "accumulated profits" are determined in a different manner and found to be $180, the allowable credit will also be halved to $10 ($20 × $80/($180 − $20)).

[3] The statutory definition of "accumulated profits" does not specifically address this question. It defines the term for purposes of Section 902 as "the amount of [the corporation's] gains, profits, or income computed without reduction by the amount of the income * * * taxes imposed on or with respect to such profits or income" (I.R.C. § 902(c)(1)). The definition goes on to provide that the Commissioner has the "full power to determine from the accumulated profits of what year or years such dividends were paid," generally "treating dividends as having been paid from the most recently accumulated gains, profits, or earnings" (*ibid.*). This latter provision reflects the fact that the credit is to be computed by considering the subsidiary's accumulated profits on an annualized basis. A dividend payment is allocated first to the accumulated profits of the most recent year and then, if those profits are insufficient to cover the amount of the dividend, to the profits of the next most recent year, and so forth. The credit is then computed separately for each year to which the dividend is traced by multiplying the foreign tax paid for that year by the appropriate fraction. The sum of those separate annual computations yields the Section 902 credit for the particular dividend. See *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. 53, 78-83 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974); *General Foods Corp.* v. *Commissioner*, 4 T.C. 209, 215 (1944).

return, however, the subsidiary reported a loss (attributable to accelerated depreciation and special inventory adjustments) that it carried back to offset virtually all of its income for 1971 and part of its income for 1970. As a result of this loss carryback, Britain refunded almost all of the income tax paid for 1971 and part of the tax paid for 1970. The 1973 loss deductions, although recognized under British law, are not allowed in computing income under the Internal Revenue Code. App., *infra,* 1a-2a, 10a-11a.

On the consolidated tax returns for 1970 and 1971, respondent claimed Section 902 foreign tax credits with respect to the dividends received from the British subsidiary. For purposes of computing the prorated credit, respondent determined the subsidiary's "accumulated profits" based on the British definition of taxable income, thereby eliminating almost all of the subsidiary's accumulated profits for 1971 and reducing them for 1970. This treatment resulted in a substantially larger Section 902 credit for respondent in 1970 and 1971, and therefore a correspondingly smaller United States income tax liability, than if respondent had computed "accumulated profits" based on the United States definition of taxable income. App., *infra,* 11a, 15a-16a.[4] The Commissioner, based on his determination that the subsidiary's "accumulated profits" must be computed under principles of United States law, asserted deficiencies in respondent's income tax of $323,654 for 1970 and $237,616 for 1971. Respondent paid the deficiencies and, after its administrative refund claim was denied, brought this refund action in the Claims Court. *Id.* at 2a-3a & n.3, 11a-12a, 23a-24a.

[4] The tax advantage was achieved by respondent in two related ways. First, the reduction in accumulated profits in 1970 correspond-

3. On cross-motions for summary judgment, the Claims Court held for the government, ruling that "accumulated profits" in Section 902 means income or profits as defined by the Internal Revenue Code, not by the tax law of a foreign country (App., *infra,* 9a-28a). The court found that this conclusion was strongly supported by Tax Court precedent (*id.* at 16a-19a) and by the language (*id.* at 19a-21a), purpose (*id.* at 22a-25a), and consistent administrative interpretation (*id.* at 25a-26a) of Section 902. With respect to the statute itself, the court explained that the dividends in the numerator of the Section 902 fraction are undeniably computed under United States law (App., *infra,* 20a) and the "accumulated profits" in the denominator are "the fund from which the dividends are paid" (*id.* at 21a). Therefore, the court concluded, it would introduce an inconsistency that would impair the proper functioning of the allocation formula if United

ingly increased the ratio of dividend to profits for that year, thereby allowing respondent to take a credit for a higher proportion of the 1970 British tax. Second, because the accumulated profits for 1971 were virtually eliminated, they were not sufficient to cover the dividend paid in that year. Accordingly, under the annualization principle of Section 902 (see note 3, *supra*), part of the 1971 dividend was attributed to profits earned in preceding years going back to 1968. Because the foreign taxes in those years were much higher than the almost nonexistent tax of 1971, respondent's allowable Section 902 credit was increased. App., *infra,* 23a-24a; C.A. App. 68-69. By contrast, because the 1973 loss and resulting carryback are not allowable under the Internal Revenue Code, they do not act to reduce the subsidiary's "accumulated profits" if those profits are computed under United States law. Without that adjustment unique to British law, the profits for 1971 are adequate to cover the dividend paid that year and therefore the 1970 and 1971 dividends can simply be treated as having been derived from the accumulated profits for the years of distribution. Because the foreign tax paid in those years was relatively small, the Section 902 credit for those years is correspondingly small. *Ibid.*

States law is not also used to compute the profits in the denominator (*ibid.*).

Based on the legislative history, the Claims Court identified three principal purposes of the Section 902 credit: (1) to provide equal treatment for unincorporated foreign branches and foreign subsidiaries; (2) to eliminate double taxation; and (3) to limit the allowable credit for foreign taxes paid by a subsidiary (when a portion of the profits is not distributed as a dividend). App., *infra,* 23a. The court found that its interpretation "effectuates congressional intent" (*ibid.*) in furthering these policies whereas respondent's interpretation would frustrate them. In particular, the court rejected respondent's contention that defining "accumulated profits" in terms of United States law would lead to double taxation in this case. The court explained that the relatively small credit that respondent receives under the court's interpretation is a direct result of the fact that its subsidiary paid very little British income tax in 1970 and 1971. *Id.* at 24a. The court concluded (*ibid.*): "To not recognize this fact as [respondent] urges would eviscerate the very purpose of the pro-rata credit and permit [respondent] a substantial windfall in avoiding other taxes with the phantom taxes deemed paid."

Finally, the court found that its holding was supported by the longstanding administrative construction embodied in Treas. Reg. § 1.902-3(c)(1) (1971 ed.). That regulation explicitly equates the term "accumulated profits" in Section 902 with the "earnings and profits" that are the source of dividends under Section 316 of the Code and that undeniably are computed under United States law. The court concluded that this unambiguous administrative construction is "consistent with the purposes enunciated by Congress when enacting the indirect tax credit legislation" (App., *infra,* 26a).

4. The court of appeals reversed (App., *infra,* 1a-8a). The court held that the "plain meaning" of Section 902 requires the conclusion that "accumulated profits" must be determined by applying the tax law of the foreign country (*id.* at 6a). The court stated that the text of Section 902(a)(1) describes the creditable foreign taxes as those paid "on or with respect to the accumulated profits of such foreign corporation," and that Section 902(c) uses similar language (App., *infra,* 6a (quoting the 1982 version of Section 902) (emphasis deleted)). The court concluded from this phrasing that "accumulated profits" must be "the actual basis on which the foreign sovereign assesses tax liability," *i.e.,* foreign taxable income as determined by foreign revenue laws (*ibid.*). The court also concluded that its interpretation is necessary to implement the statutory goal of preventing double taxation, stating that determining "accumulated profits" under United States law would defeat this goal by "severing the relationship" between the foreign taxes paid by the subsidiary and the accumulated profits with respect to which those taxes are paid (*ibid.*). The court rejected the Tax Court precedent relied upon by the Claims Court as "fail[ing] to address the controversy raised in the instant case" (*id.* at 7a), and it did not discuss at all the settled administrative construction that is directly contrary to its decision.

REASONS FOR GRANTING THE PETITION

The court of appeals has erroneously held that Congress intended the term "accumulated profits" in Section 902 of the Code to mean a foreign country's definition of taxable income. The court's decision thus overturns the construction of the statute that has long been settled. Moreover, the decision is seriously antithetical to the purposes of the statute and will reintroduce some of the disparities in tax treatment that it was designed to eliminate. And this major disruption of the statutory scheme rests on an unusually weak foundation—a "plain meaning" discussion that manifestly misunderstands the operation of the Section 902 credit.

While the court of appeals' decision involves a technical issue, it will have enormous deleterious consequences on the public fisc and on the fair administration of the tax laws if it is permitted to stand. Because the decision below is by a court of nationwide jurisdiction, the error places the Treasury in a whipsaw posture. Taxpayers whose particular situation makes it advantageous for them to invoke the erroneous construction below can arrange to have their case heard in the Claims Court where the decision below will be binding precedent. Other taxpayers for whom the Federal Circuit's erroneous construction is not advantageous can continue to use the previously well-settled rule that accumulated profits are computed under United States law. Because this issue typically involves contested tax liabilities of considerable magnitude, the decision below creates the opportunity for a substantial windfall for many multinational corporations. It is therefore appropriate for this Court to grant certiorari to correct the error of the court below and establish uniformity in the application of the indirect foreign tax credit.

1. The court of appeals in this case has overturned, with little more than perfunctory analysis, the well-settled construction of an important statute governing the taxation of multinational corporations. For more than 50 years, the Treasury has consistently interpreted accumulated profits using principles of United States taxation. In 1933, the Commissioner took the position that "the amount of the accumulated profits" is "based as a fundamental principle upon all income of the foreign corporation available for distribution to its shareholders, *whether such profits be taxable by the foreign country or not.*" I.T. 2676, XII-1 C.B. 48, 50 (1933) (emphasis added).

Accordingly, he ruled that, in order to determine "accumulated profits" under the predecessor of Section 902, the income on which the foreign taxation of a subsidiary is based must be adjusted for special deductions unique to foreign law that do not reduce the subsidiary's income or surplus available for the distribution of dividends under United States law (XII-1 C.B. at 51).

This position was embodied in a formal regulation in 1965. Treas. Reg. § 1.902-1(e) (originally promulgated as Treas. Reg. § 1.902-3(c)(1) (1965 ed.)) defines the accumulated profits of a foreign subsidiary for a taxable year as "the sum of (1) the *earnings and profits* of such corporation for such year, and (2) the foreign income taxes imposed on or with respect to the gains, profits and income to which such earnings and profits are attributable" (emphasis added). "Earnings and profits" is an established term that represents the source of payments treated as dividends under Section 316 of the Code, and there is no doubt that its calculation is based upon the rules for determining United States taxable income. See, *e.g.*, I.R.C. § 312; B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 7.03 (5th ed. 1987). The Commissioner has explained that "accumulated profits" under Section 902 are similar to "earnings and profits" under Section 316 because the term "dividends" has precisely the same meaning in both sections and "both 'accumulated profits' and 'earnings and profits' denote the same source from which 'dividends' are paid" (Rev. Rul. 63-6, 1963-1 C.B. 126, 128). The Commissioner has consistently adhered to this position. See, *e.g.*, Rev. Rul. 87-72, 1987-2 C.B. 170; Rev. Rul. 87-14, 1987-1 C.B. 181.

Although this established administrative interpretation has, for the most part, not been challenged in litigation, it

has been approved by the Tax Court on two occasions. In its reviewed decision in *Steel Improvement & Forge Co.* v. *Commissioner*, 36 T.C. 265, 276-282 (1961), rev'd on other grounds, 314 F.2d 96 (6th Cir. 1963), the Tax Court held that a foreign subsidiary's accumulated profits under Section 902 were not reduced by a loss and carryback that were allowed by Canadian law but would not be allowed under United States tax law, stating that "the accumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law" (36 T.C. at 277). In *Champion International Corp.* v. *Commissioner*, 81 T.C. 424, 446-447 (1983), the Tax Court discussed *Steel Improvement* and reaffirmed this holding. The court unequivocally stated that "[a]ccumulated profits are determined under American law rather than foreign law" (*id.* at 447).

The leading treatises and commentaries on the foreign tax credit likewise have concluded that accumulated profits must be computed under concepts of United States taxation.[5] And Congress, in the course of amending the foreign tax credit provisions in other respects in 1986 (see pages 24-25, *infra*), explicitly noted its recognition that, under existing law, "accumulated profits * * * are generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes" (S. Rep. No. 313, 99th Cong., 2d Sess. 299 (1986)). The Senate Report cited *Steel Improvement*, Treas. Reg. § 1.902-1(e), and Rev. Rul. 63-6, *supra*, as evidencing this

[5] See 1 E. Owens & G. Ball, *The Indirect Credit* 161-162 (1975); E. Owens, *The Foreign Tax Credit* 119-121 (1961); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.11, at 17-44 (5th ed. 1987); Schoenfeld, *Some Definitional Problems in the Deemed Paid Foreign Tax Credit of Section 902: "Dividends" and "Accumulated Profits"*, 18 Tax L. Rev. 401, 407-421 (1963); Eigner, *The Foreign Tax Credit*, 39 Taxes 724, 729-730, 736 (1961).

settled proposition. S. Rep. No. 313, *supra*, at 299 n.6. See also H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 841 (1984) (for purposes of the "deemed paid" credit, "accumulated profits are essentially equivalent to earnings and profits").

This established interpretation of "accumulated profits" accords with the general principle concerning the construction of the foreign tax credit provisions that was laid down by this Court in *Biddle* v. *Commissioner*, 302 U.S. 573 (1938). The Court there stated that, because the subject matter of the Code is the computation of United States income tax, it should be presumed that Congress intended that "its own criteria" would be used to interpret the terms of the statute (*id.* at 578). The Court explained that this presumption could be rebutted only if "the statute, by express language or necessary implication, makes the meaning of the phrase * * * depend upon its characterization by the foreign statutes" (*ibid.*). Under this principle, the Court in *Biddle* held that the phrase "income taxes paid or accrued" in a predecessor to Section 901(b)(1) was to be interpreted in accordance with United States tax law, finding "nothing in [the statute's] language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation" (*id.* at 578-579).

2. a. The court of appeals departed from the well-established interpretation of Section 902 in a remarkably casual fashion. Despite this Court's repeated admonition that Treasury regulations, "if found to 'implement the congressional mandate in some reasonable manner,' must be upheld" (*National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979), quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973)), the court of appeals did not discuss, or even acknowledge, the applicable

regulation. The court barely adverted (see App., *infra*, 6a) to this Court's decisions construing the foreign tax credit. And the court dismissed the Tax Court's clear approval of the interpretation embodied in the regulations by concluding that the Tax Court has misconstrued its own precedent (*id.* at 7a-8a). Instead, the court relied almost entirely on what it found to be the "plain meaning" of Section 902. The court's analysis, however, is based on a faulty reading of the text of the statute. Moreover, the court's holding is clearly antithetical to the statutory design and purposes.

The court of appeals' holding rests almost exclusively on one phrase in Section 902 read in isolation. Because the statute refers to foreign taxes paid "on or with respect to * * * accumulated profits" (§ 902(a)(1); see also § 902(c)(1)), the court held that "accumulated profits" must be defined as the "actual basis on which the foreign sovereign assesses tax liability," *i.e.*, taxable income computed under foreign law (App., *infra*, 6a). But this reasoning, which in any event hardly represents a "plain meaning" construction, completely loses its force when the entire statute is examined. Section 902(a)(1) goes on to refer to the "dividends * * * paid by such foreign corporation out of accumulated profits." It is these "dividends" that are subjected to United States income tax, and Section 316 of the Code makes clear that payments are treated as "dividends" to the extent that their source is "earnings and profits".[6] Hence, the text of Section 902 essentially identifies "accumulated profits" with "earnings and profits." Even the court below recognized "the undisputed and well-settled fact that 'the determination of a foreign

[6] If a distribution to shareholders exceeds the available "earnings and profits," both current and historic, the excess is not a dividend, but rather a return of capital. See I.R.C. § 301(c).

corporation's *earnings and profits* * * *, for purposes of the imposition of the U.S. tax, is to be made by the application of U.S. tax principles' " (App., *infra*, 7a, quoting *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. 53, 69 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974)). Thus, the court of appeals' approach to parsing the statute equally points to the conclusion that "accumulated profits" are computed under United States law.

It is therefore apparent that the "plain meaning" of the statute does not provide an adequate basis for the court of appeals' decision. Indeed, if any "plain meaning" can be gleaned from examination of the statute alone, it is the meaning suggested by the general principle of *Commissioner* v. *Biddle, supra*—namely, that provisions of the Internal Revenue Code governing the computation of domestic income taxes are to be interpreted in accordance with United States law in the absence of some express indication to the contrary. When one examines the purposes of Section 902 and the way in which the credit is designed to work, it becomes manifest that the amount of "accumulated profits" is to be determined in accordance with United States tax law.

b. The term "accumulated profits" was introduced into the ratio for computing the indirect foreign tax credit by Section 238(e) of the Revenue Act of 1921, ch. 136, 42 Stat. 259. As this Court explained in *American Chicle Co.* v. *United States*, 316 U.S. 450, 453-454 (1942), this change was made because the original version, which computed the credit on the basis of the ratio between dividends and total taxable income, did not adequately achieve its purpose of preventing double taxation. "The difficulty with it was that it did not relate the credit to the accumulated profits or surplus of the subsidiary *out of which the dividends were paid*" (*id.* at 453 (emphasis added)). For example, if the subsidiary made no profit and paid no foreign tax in a

particular year, yet distributed a dividend out of surplus, the pre-1921 statute would not have allowed any credit because there was no taxable income in the year in which the dividend was distributed. The new statute was designed "to permit identification of the accumulated profits out of which the dividend might have been paid and to give credit for a proportion of the subsidiary's taxes attributable to such accumulated profits" (*id.* at 454).

Since the correct computation of the credit requires identification of the profits out of which the dividend was paid, which is a concept defined under United States law (see I.R.C. §§ 312, 316; page 12, *supra*), the Claims Court correctly stated that the interpretation subsequently adopted by the court of appeals introduces an "[a]lgebraic [in]consistency" (App., *infra*, 21a) that prevents the Section 902 credit from working properly to preclude double taxation. The goal of the prorated credit is to apportion the foreign tax to the domestic parent based on the "dividends" that it receives from the subsidiary and must treat as taxable income on its United States return. Accordingly, the term "dividends" in the numerator of the Section 902 fraction plainly has the meaning assigned to it by Section 316 of the Internal Revenue Code. The "accumulated profits" in the denominator simply represent the fund from which the dividends are paid; the total accumulated profits are the pool of potential dividends, *i.e.*, the maximum earnings of the subsidiary that would be taxed as dividends if distributed to the parent. Just as United States tax concepts determine whether the actual distribution made by the subsidiary is taxed as a dividend, so too they must determine what is the maximum amount of the subsidiary's earnings that could be distributed as a dividend, *i.e.*, the "accumulated profits." The determination of "accumulated profits" under principles of United

States law thus is required to correlate the Section 902 fraction's numerator (the actual dividends) with its denominator (the potential dividends), thereby providing a coherent ratio by which to compute the share of foreign tax that has been borne by the distributed portion of the subsidiary's total earnings.

The extent to which the court of appeals' interpretation of Section 902 disrupts the proper functioning of the credit is illustrated by the simple example provided earlier (see note 2, *supra*). If the foreign subsidiary earns $100 of profit, pays $20 in foreign taxes and distributes the remaining $80 to its parent as a dividend, the parent is entitled to the full $20 credit ($20 × $80/($100 − $20)). This result is obviously correct; when the subsidiary distributes to the parent all of the funds available for dividends, the parent should be entitled to a credit for all of the foreign taxes paid. This result is achieved, however, only if "accumulated profits" are defined under United States law. If, on the same facts, the foreign country does not allow an $80 deduction that is permitted by United States law and therefore the "accumulated profits" determined under foreign law would be $180, application of the court of appeals' interpretation would halve the parent's credit to $10 ($20 × $80/($180 − $20)), even though the parent took into income 100% of the amount of earnings available for distribution as a dividend. Thus, the court of appeals' approach, in divorcing the credit from the fund out of which the dividends are paid, would reintroduce some of the "eccentric results" that the 1921 legislation was designed to eliminate (see *American Chicle Co.* v. *United States*, 316 U.S. at 453).

The above analysis is reflected and strongly supported by this Court's decision in *American Chicle* itself. The

court there construed the very phrase upon which the court of appeals placed reliance—taxes "paid * * * with respect to the accumulated profits" of the subsidiary (see 316 U.S. at 451). At that time, the predecessor of Section 902 defined "accumulated profits" as after-tax profits. The question presented was not the meaning of that term, but rather the meaning of the entire "taxes paid" clause—whether the foreign tax that is the starting point for computing the credit should be the total tax paid on the subsidiary's pre-tax profits or instead a smaller amount that reflects the proportion of total tax *attributable to the after-tax profits.* The Court agreed with the government that Congress had intended the latter result.[7] The Court explained (*id.* at 452-453):

> If, as admitted, the purpose is to avoid double taxation, the statute, as written, accomplishes that result. The parent receives dividends. Such dividends, not its

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[7] The nature of the dispute in *American Chicle* is best explained with the help of an example. If the subsidiary had $200 in income and paid a foreign tax of $20, it would have had $180 in "accumulated profits" as then defined. If the subsidiary had distributed the $180 as a dividend, the taxpayer's position in *American Chicle* was that it would be entitled to a $20 credit. The Court rejected this position, however, finding that $20 was the amount of taxes paid on the subsidiary's pre-tax income, not the amount paid "with respect to the accumulated profits" of $180. Thus, under the so-called *American Chicle* limitation, the taxpayer was entitled to a credit of only $18, the foreign tax apportionable to the $180 of accumulated profits.

In 1962, Congress amended Section 902 to accomplish a similar result by redefining "accumulated profits" as the pre-tax income of the subsidiary, but at the same time adding Section 78 of the Code, which requires the parent to take into income ("gross-up") the amount of the allowable foreign tax credit. Under that approach, applicable for the tax years at issue in this case, the credit is first computed without the *American Chicle* limitation, but this change is offset by treating the credit itself as income to the parent. See, *e.g.*, *H.H. Robertson* v. *Commissioner*, 59 T.C. at 77 & n.13. This adjustment is necessary to achieve maximum parity between the tax treatment of foreign

subsidiary's profits, constitute its income to be returned for taxation. The subsidiary pays tax on, or in respect of, its entire profits; but, since the parent receives distributions out of what is left after payment of the foreign tax, that is, out of what the statute calls "accumulated profits," it should receive a credit only for so much of the foreign tax paid as relates to or, as the Act says, is paid upon, or with respect to, the accumulated profits.

The lesson of *American Chicle* is that the touchstone for computing the prorated Section 902 credit is the maximum amount of the subsidiary's earnings available for distribution as dividends. Amounts that are not available for distribution as dividends are not relevant in making the proration. Thus, in *American Chicle*, the amount of the subsidiary's earnings paid as foreign taxes would never be available for distribution as dividends; hence, the amount of foreign tax attributable to those earnings was not creditable. Correspondingly here, the amount of the subsidiary's income computed under foreign law principles does not define the maximum amount available for distribution as a dividend. It is that latter amount, the "earnings and profits" computed under United States law, that must be the benchmark for computing the allowable portion of the credit.

In sum, the statutory design is that the allowable credit shall be the proportion of the foreign tax that the dividends actually received bear to the potential dividends. That approach confines the credit to the amount necessary to prevent double taxation. It can be implemented only if "accumulated profits" are computed under United States law so that they reflect potential dividends.

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branches and foreign subsidiaries. See pages 19-22, *infra*; B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-45 to 17-47.

By contrast, the court of appeals here fallaciously reasoned that its interpretation furthers the statutory purpose of preventing double taxation (App., *infra*, 6a-7a). But determining "accumulated profits" under United States law does not prevent "tax payments already made to the foreign country" from being "fully recoverable as tax credits," as the court of appeals claimed (*ibid.*). The fact that respondent's credit on its 1970 and 1971 tax returns is reduced when accumulated profits are determined under United States law is a consequence, not of double taxation, but of the fact that respondent's subsidiary paid little foreign tax in those years as a result of the special loss and carryback available under British law. Because most of the subsidiary's profits carried out by the dividend distribution had escaped British taxation owing to the loss carryback, they were taxed for the first time, not the second, when included in respondent's United States income. What respondent is seeking is a tax credit based on "phantom taxes" that the British subsidiary was able to escape paying to Britain because of the loss carryback; the Claims Court correctly characterized that result—adopted by the court of appeals—as a "substantial windfall" to respondent (App., *infra*, 24a).

c. As the Claims Court found (App., *infra*, 23a, 24a-25a), the interpretation subsequently adopted by the court of appeals also undermines one of the primary congressional policies that pervades the foreign tax credit provisions—namely, to provide companies, like respondent, that operate their foreign business through a separately incorporated foreign subsidiary with the same relief from double taxation that is provided to companies that operate through a foreign branch. A foreign branch is simply a part of the larger domestic company, and all of its income earned in a foreign country is automatically income to the

subsidiary's profits, constitute its income to be returned for taxation. The subsidiary pays tax on, or in respect of, its entire profits; but, since the parent receives distributions out of what is left after payment of the foreign tax, that is, out of what the statute calls "accumulated profits," it should receive a credit only for so much of the foreign tax paid as relates to or, as the Act says, is paid upon, or with respect to, the accumulated profits.

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larger domestic company and subject to taxation on its United States income tax return. Since 1918, the domestic company has been entitled to take a credit against its United States income tax for the foreign income taxes paid by its branch; this is the "direct" credit provided in Section 901 of the Code.

The purpose of the indirect credit of Section 902 is to extend the benefit of the foreign tax credit to domestic companies that operate through a foreign subsidiary (and therefore do not "directly" pay the foreign tax). As a Treasury spokesman stated in connection with the 1921 legislation that made the amount of the credit depend upon the subsidiary's "accumulated profits" (see pages 14-15, *supra*), an American corporation operating through a foreign subsidiary is "economically and practically" in the same position as one operating through a foreign branch and "[t]he proposal is to give this American corporation about the same credit as if conducting a branch" (*Hearings on H.R. 8245 Before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 389 (1921) (statement of Dr. Adams)). See also *Associated Telephone & Telegraph Co.* v. *United States*, 306 F.2d 824, 832 (2d Cir. 1962), cert. denied, 371 U.S. 950 (1963). The provision involved in this case, which prorates the credit when the subsidiary does not return all of its earnings to the parent, was enacted to prevent the corporation operating through a subsidiary from receiving a *greater* tax benefit than one operating through a branch. See 61 Cong. Rec. 7184 (1921) (statement of Sen. Smoot). And subsequent amendments to the foreign tax provisions have been designed in part to improve attainment of this goal of putting the two similar modes of conducting foreign business on an equal footing for foreign tax credit purposes. See S. Rep. No. 313, 99th Cong., 2d Sess. 306 (1986) (change designed "to provide more similar results" for branch and subsidiary

operations); S. Rep. No. 1881, 87th Cong., 2d Sess. 66-67 (1962) ("gross-up" adjustment of I.R.C. § 78 necessary to eliminate tax advantage of subsidiary operation over branch operation); see generally B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-45 to 17-47.

The decision of the court of appeals undermines this congressional policy by introducing major disparities in the treatment of companies depending upon whether they operate through a subsidiary or a branch. Foreign concepts of taxable income play no role in determining whether the earnings of a foreign branch constitute income in the hands of its domestic owner; those earnings flow directly to the owner and are recognized according to United States tax principles. To keep the two business arrangements on an equal footing, the accumulated profits of a foreign subsidiary must approximate the earnings that would be recognized by the parent if it were operating as a branch, *i.e.*, they must be computed under United States law. The correctness of this conclusion is illustrated by the basic example provided earlier (page 16, *supra*), where the foreign entity pays $20 in foreign tax on profits computed at $100 under United States law and $180 under foreign law. A foreign branch would be treated as having funneled all of its profits (which would be $100 computed under United States law) to the domestic company, and it would receive the full $20 "direct" credit under Section 901. If the same business were conducted by a foreign subsidiary, however, and the subsidiary distributed all of its after-tax profits to the parent, the court of appeals' approach would permit it take a credit for only part of the foreign taxes paid ($20 × $80/($180 − $20) = $10). Computing accumulated profits under United States law, conversely, would yield the correct result of a full $20 credit.

In this example, the foreign measure of income is higher than that under United States law, and therefore the result

under the court of appeals' approach is to understate the credit to the prejudice of the company operating through a subsidiary. If, as in the present case, the foreign definition of income yields a figure lower than that computed under United States law, the allowable credit will increase, thereby conferring a windfall benefit on the company that operates as a subsidiary. In both cases, however, the court of appeals' approach subverts the clearly expressed legislative policy to avoid discrimination between the two methods of doing business abroad.

In short, like the direct credit granted to a domestic company that operates through a foreign branch, the indirect credit of Section 902 treats the amount of foreign tax paid as a fact. It is not concerned with how the foreign tax is computed or with the foreign income base on which it is imposed. It simply takes the amount of foreign tax paid and apportions it in accordance with the fractional share of the subsidiary's United States income that is actually distributed as a dividend. To make the credit work properly, the term "accumulated profits" in Section 902 must refer to income computed under United States tax principles.

3. a. The decision below is of enormous importance to the public fisc and creates a serious problem for the fair administration of the tax laws. It is doubtful whether there is any foreign country whose income tax laws accord with those of the United States in every respect. Thus, the question presented here can arise no matter where a foreign subsidiary of a domestic corporation does business; it is likely to affect many large multinational corporations. While it is too early to quantify the potential impact of the decision below with any confidence, it is clearly very substantial. According to IRS statistics, in 1982 (the most recent year for which such figures are available), domestic

companies controlled more than 25,000 foreign subsidiaries doing business in more than 100 countries, and these companies claimed more than $9 billion in Section 902 credits for foreign taxes paid by those subsidiaries. A preliminary survey of IRS field offices indicates that, in cases currently under audit, there are about 30 refund claims based on the decision in this case that have been, or will be, filed—totalling about $150 million. In addition, the IRS estimates, as a result of communications with other taxpayers, that another 150 refund claims totalling $750 million will be filed in reliance on the decision below.

The massive revenue impact of the decision below is compounded by the fact that the court of appeals' decisions places the IRS in a whipsaw posture. The Federal Circuit is a court of nationwide jurisdiction. Any taxpayer, regardless of where it is domiciled or does business, is free to pay the contested tax and to sue for a refund in the Claims Court, with appellate review in the Federal Circuit. Thus, taxpayers can compute their Section 902 credit for a given tax year under both the traditional approach and the approach adopted by the court below and then elect the more favorable tax treatment by simple forum-shopping. If computation of accumulated profits under United States principles yields more favorable tax treatment, the taxpayer can rely upon the longstanding rule embodied in the Treasury regulations. On the other hand, if computing accumulated profits under foreign law principles yields a more favorable tax result, the taxpayer can realize a windfall like respondent's by litigating in the Claims Court. The Treasury would be caught in a no-win position, and evenhanded enforcement of the foreign tax credit provisions would be severely compromised. Moreover, the availability of such a tax-saving option to well-counseled companies that operate foreign subsidiaries

would further undermine the congressional goal of equality of treatment between companies that operate through foreign subsidiaries and those that operate through foreign branches (which always calculate their income from foreign operations under United States tax principles) (see pages 19-22, *supra).*

Finally, the court of appeals' decision also would impose new and formidable burdens on revenue agents and the courts. Under the heretofore settled rule, the foreign tax credit is computed solely by reference to the familiar principles of the Internal Revenue Code; the vagaries of foreign tax law play no role. The court of appeals' approach, however, would require that the court determine the taxpayer's accumulated profits under unfamiliar foreign principles of tax law, which may be difficult to ascertain and may contain concepts of profits and taxable income that are profoundly different from those of the United States. This imposition of a "shifting standard * * * adopted by reference to foreign characterizations and classifications of tax legislation" (*Biddle* v. *Commissioner,* 302 U.S. at 578-579) would create an unwelcome administrative and judicial burden. For all of these reasons, review by this Court is warranted to correct the court of appeals' erroneous and troublesome interpretation of the foreign tax credit provisions.

b. The prospective impact of the decision below has been diminished somewhat by Section 1202(a) of the Tax Reform Act of 1986, Pub. L. No. 514, 100 Stat., 2528. In that statute Congress prospectively changed the operation of the Section 902 credit to eliminate the "annualization" approach, *i.e.,* the manner in which the dividend is matched to accumulated profits on a year-by-year basis (see note 3, *supra*). Because Congress believed that this scheme was subject to manipulation by taxpayers and also subject to other problems, it provided that retained earnings after 1986 would all go into one "pool," which would be the source of the dividends. See generally S. Rep. No. 313, *supra*, at 305-306; B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-47 to 17-48. Congress accomplished this change by redrafting Section 902, including replacing the term "accumulated profits" with the term "post-1986 undistributed earnings." The latter term is defined as the "earnings and profits" of the foreign subsidiary accumulated in years after 1986 and computed "according to rules substantially similar to those applicable to domestic corporations" (see 26 U.S.C. 902(c)(1) (Supp. IV 1986) and 964(a)). Thus, while the 1986 legislation was not directed at the question presented in this case, its language will not support respondent's construction, and it would appear extremely unlikely that even the Federal Circiut would hold that foreign law principles must be used to determine the post-1986 earnings to be used in the prorated indirect credit computation.[8]

Despite the 1986 amendment, however, the issue presented in this case retains substantial continuing importance. Congress recognized that many foreign subsidiaries had retained pre-1987 profits, but it nevertheless decided that the 1986 amendment would operate only prospectively on post-1986 earnings; it specifically provided that prior law would continue to govern the distribution of pre-1987 earnings.[9] In other words, Congress deliberately per-

[8] As we have noted (pages 11-12, *supra*), Congress clearly believed that it was perpetuating existing law in defining the subsidiary's profits to be used in the proration formula in terms of United States tax principles.

[9] Section 902(c)(6)(A) (Supp. IV 1986) of the new statute provides:

> In the case of any dividend paid by a foreign corporation out of accumulated profits (as defined in this section as in effect on the day before the date of the enactment of the Tax Reform Act of

petuated the pre-1986 statute, to the extent that a dividend distributed in later years comes out of pre-1987 earnings. It is not uncommon to have to go back a number of years to trace a dividend to the accumulated profits or earnings out of which it is paid. See, *e.g.*, *H. H. Robertson* v. *Commissioner*, 59 T.C. at 81 (dividend issued in 1965 attributed to accumulated profits of 1952-1964). Indeed, in this case the court of appeals' approach allows respondent to treat part of its 1971 dividend as having been paid out of its 1968 accumulated profits (see note 4, *supra*). Moreover, because dividends are attributed to accumulated profits on a last-in, first-out basis (see 26 U.S.C. 902(c)(6)(B) (Supp. IV 1986)), a corporation's dividend could still be derived, many years into the future, from pre-1987 accumulated profits, thus triggering the issue in this case. Therefore, although its prospective impact for post-1986 tax years has been diminished by the 1986 legislation, the decision below will continue to have deleterious consequences for the administration of the foreign tax credit for tax years well beyond 1986. And, of course, the 1986 legislation has no effect at all on the numerous and substantial refund claims that are likely to be filed for open tax years prior to 1987. Accordingly, the decision below is of considerable continuing importance, and review by this Court is warranted to correct the court of appeals' error and restore even-handed administration of this important aspect of the tax laws.

1986) for taxable years beginning before the 1st taxable year taken into account in determining the post-1986 undistributed earnings of such corporation—

(i) this section (as amended by the Tax Reform Act of 1986) shall not apply, but

(ii) this section (as in effect on the day before the date of the enactment of such Act) shall apply.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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March 1989

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 88-1201

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, PLAINTIFF-APPELLANT

v.

THE UNITED STATES, DEFENDANT-APPELLEE

Decided: Aug. 31, 1988

[Filed Aug. 31, 1988]

Before NEWMAN and BISSELL, Circuit Judges and RE, Chief Judge.*

BISSELL, Circuit Judge.

The Goodyear Tire & Rubber Company and Affiliates (collectively, Goodyear) appeal the decision of the United States Claims Court, *Goodyear Tire & Rubber Co. v. United States,* 14 Cl. Ct. 23 (1987), granting summary judgment to the United States and holding that Goodyear was not entitled to a tax refund. Judgment was entered dismissing the complaint. We reverse.

BACKGROUND

Goodyear Tire & Rubber Company (Goodyear U.S.) is the parent of the consolidated group of United States cor-

* The Honorable Edward D. Re, Chief Judge, United States Court of International Trade, sitting by designation pursuant to 28 U.S.C. § 293(a) (Supp. IV 1986).

porations constituting the appellant. The Goodyear Tyre & Rubber Company (Great Britain) Limited (Goodyear U.K.) is a British corporation and a wholly owned subsidiary of Goodyear U.S.

During 1970 and 1971, Goodyear U.K. derived profits from business activities it conducted in Great Britain and, to a lesser extent, the Republic of Ireland. In each of these years, Goodyear U.K. first paid income taxes on profits to the governments of Great Britain and Ireland, and then distributed dividends to Goodyear U.S. When Goodyear U.S. reported these dividends for American tax purposes, it claimed foreign tax credits as allowed under section 902 of the Internal Revenue Code of 1954.

In 1972 and 1973, Goodyear U.K. incurred net operating losses. The 1973 loss is particularly illustrative of the issue presented because that loss included British tax deductions[1] that were not allowable under American tax laws. For British tax purposes, the 1971 and 1970 records of Goodyear U.K. were adjusted to "carry back" the 1973 loss.[2] These loss carry-back adjustments resulted in the British government refunding to Goodyear U.K. the tax payments it had made for 1971 and 1970.

In light of those refunds, the Commissioner of the Internal Revenue Service (IRS) redetermined, for foreign tax credit purposes, the 1971 and 1970 records of Goodyear U.S. The IRS based its redetermination on American tax law. Because American law did not recognize the 1973

[1] One deduction permitted accelerated depreciation write-offs, and the other permitted a special inventory reduction.

[2] A 1972 loss eliminated the 1972 accumulated profits and a portion of the 1971 accumulated profits. Therefore, the 1973 loss was applied back to 1971 and 1970 accumulated profits. The 1973 loss carry-back eliminated all accumulated profits for 1971, and substantially reduced the accumulated profits of 1970.

deductions permitted under British law, the IRS's redetermination converted the 1973 Goodyear U.K. loss to a profit, obviating the need to carry back any losses to 1971 and 1970. Therefore, under American tax law, Goodyear U.K. recorded profits for 1971 and 1970, yet because of the tax refunds, there was effectively no longer any foreign tax assessed on those profits. The IRS accordingly determined that Goodyear U.S. was not entitled to the foreign tax credits previously taken because there was no double taxation. Consequently, the IRS assessed $791,240.72[3] against Goodyear U.S. to recover the resultant tax deficiency.

Goodyear U.S. paid the deficiency and then filed timely refund claims. The IRS denied the refund claims in 1983. Thereafter, Goodyear U.S. filed suit in the United States Claims Court seeking a refund. Goodyear U.S. asserted that the IRS had erred by incorrectly applying American instead of British tax law in its redetermination of accumulated profits.

The Claims Court (1) held that accumulated profits under section 902 must be calculated in accordance with American tax law, and (2) found Goodyear U.S. was not entitled to a tax refund. Goodyear U.S. appeals the Claims Court decision.

ISSUE

Whether 26 U.S.C. § 902(a) requires accumulated profits to be computed under American or foreign tax law.

[3] The recomputation resulted in tax assessments of $323,654 (1970) and $237,616 (1971) plus interest penalties of $132,611.66 (1970) and $97,359.06 (1971) to total $791,240.72.

OPINION

Under section 902(a), foreign tax credits are computed in the following manner:

> [A] domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

26 U.S.C. § 902(a) (1982). This statute establishes a relationship between the foreign taxes paid (T), the dividends received by the domestic corporation (D), and the accumulated profits (P) from which the dividends were derived. This relationship is represented by the following mathematical expression:

Section 902 Formula

(C) Section 902 Credit	=	(T) Foreign Income Tax Paid By Foreign Subsidiary	×	(D) Dividend Received by Domestic Parent ÷ (P) Accumulated Profits of the Foreign Subsidiary Minus Foreign Tax Paid

See, e.g., Champion Int'l Corp. v. Commissioner, 81 T.C. 424, 429 (1983); *H. H. Robertson Co. v. Commissioner*, 59 T.C. 53, 77 (1972), *aff'd*, 500 F.2d 1399 (3d Cir. 1974).

Section 902(c)(1) recognizes the power of foreign countries to tax "gains, profits, and income" derived within their territories. "T" in the above equation, therefore, is the amount of tax actually imposed on a foreign subsidiary by a foreign government under foreign tax law. *See Biddle v. Commissioner*, 302 U.S. 573, 578 (1938) (stating that foreign law governs when express language or necessary implication of American statute requires). The parties do not dispute this.

The parties do, however, contest whether American or British law controls the definition of "accumulated profits"—"P" in the equation. The government maintains that American law must govern the definition of "P", while Goodyear asserts that British law controls. In resolving this issue, the court notes that the term "accumulated profits" is used in the Internal Revenue Code only with reference to foreign tax credit. For the reasons discussed below, we agree with Goodyear.

Section 902(a) states that a parent corporation may obtain a tax credit on "*taxes paid* . . . by such foreign [subsidiary] corporation *to any foreign country . . . on or with respect to the accumulated profits of such foreign corporation* . . . ." (Emphasis added.) The definition of "accumulated profits" provided in section 902(c) similarly relates the foreign taxes paid to accumulated profits:

> For purposes of this section [Foreign Tax Credit], the term *"accumulated profits" means,* with respect to any foreign corporation, *the amount of* its *gains, profits, or income computed without reduction by* the amount of the income, war profits, and excess profits *taxes imposed on or with respect to such profits or income* by any foreign country or by any possession of the United States. (Emphasis added.)

26 U.S.C. § 902(c)(1) (1982).

These provisions establish that "P" is the actual basis on which the foreign sovereign assesses tax liability. Because "T" is the actual tax imposed by the foreign government, "P" must also be the basis to which the foreign government applies its own tax law in computing "T". Rev. Rul. 74-310, 1974-2 C.B. 205 (foreign income tax to be used in section 902 computation is amount of tax imposed on total profits as measured by foreign standards). For this reason, we find the plain meaning of the statute requires "P" to be determined under foreign law.

Congress' rationale for enacting section 902 supports our interpretation. "[T]he fundamental purpose of the foreign tax credit is the elimination of international double taxation." *Robertson*, 59 T.C. at 74; *see also American Chicle Co. v. United States*, 316 U.S. 450, 452 (1942); *National Cash Register Co. v. United States*, 400 F.2d 820, 825-26 (6th Cir. 1968), *cert. denied*, 394 U.S. 917 (1969); *Steel Improvement & Forge Co. v. Commissioner*, 36 T.C. 265, 282 (1961), *rev'd on other grounds*, 314 F.2d 96 (6th Cir. 1963). The IRS position that accumulated profits must be determined under American tax law, however, can defeat this purpose by severing the relationship between "T" and "P".

In the instant case, because American tax law did not recognize the 1973 loss, the IRS-computed accumulated profits of Goodyer U.K. for 1970 and 1971 were higher than the amounts recognized under British law. Adopting the IRS view inflates "P", the denominator in the section 902(a) formula. When the numerator "D" is constant, an increase in the denominator will reduce the maximum amount of tax credit available. Such a reduction prohibits the taxpayer from being able to obtain a tax credit for the full amount of the foreign taxes paid. Therefore, the tax payments already made to the foreign country will not be

fully recoverable as tax credits to reduce the subsequent tax assessments by the United States government. This effectively results in a double taxation that contravenes the purpose of the statute.

In support of its position, the IRS suggests a long history of precedents for using American law to determine accumulated profits. However, the cases presented in support of the IRS's position fail to address the controversy raised in the instant case. Rather, the cases cited recognize the undisputed and well-settled fact that "the determination of a foreign corporation's *earnings and profits* [not accumulated profits], for purposes of the imposition of the U.S. tax, is to be made by the application of U.S. tax principles." *Robertson*, 59 T.C. at 69 (emphasis added); *Steel Improvement*, 36 T.C. at 277, *rev'd on other grounds*, 314 F.2d 96 (1963); *see also Untermyer v. Commissioner*, 24 B.T.A. 906, 912 (1931), *aff'd*, 59 F.2d 1004 (2d Cir.), *cert. denied*, 287 U.S. 647 (1932). These cases only support the distinction between computing *accumulated profits* for foreign tax credit purposes, and computing *earnings and profits* for dividend characterization purposes.

The one unpublished case, not cited by the IRS, but which supports its outcome, *Pacific Gamble Robinson Co. v. United States*, No. 5155, 62-1 U.S. Tax Cas. (CCH) § 9,160 (W.D. Wash. Dec. 15, 1961) (plaintiff was not entitled to foreign tax credit when foreign tax for period in which dividend arose was refunded), was specifically rejected by the Tax Court in *Champion*, 81 T.C. at 443 n.29.

The IRS nevertheless relies on *Champion* for the holding that "*[a]ccumulated profits* are determined under American law rather than foreign law." *Champion*, 81 T.C. at 447 (citing *Steel Improvement*, 36 T.C. at 277) (emphasis added). However, such reliance is misplaced. The *Champion* dictum misstated the actual text of *Steel*

Improvement which stated that "accumulated *earnings and profits* . . . are to be determined under American rather than foreign law." *Steel Improvement*, 36 T.C. at 277 (emphasis added). The determination of "accumulated earnings and profits" for United States income tax purposes is distinguishable from the determination of "accumulated profits" for deemed foreign tax credit purposes. Absent this point of confusion, *Steel Improvement* and *Champion* are consistent with the court's position.

CONCLUSION

In light of the foregoing, we reverse, as a matter of law, the judgment of the Claims Court and find that "accumulated profits," for purposes of determining deemed paid foreign tax credits, are to be based upon foreign law.

REVERSED

APPENDIX B

IN THE UNITED STATES CLAIMS COURT

No. 510-85T

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

(Filed: Dec. 8, 1987)

ORDER

TIDWELL, Judge:

This tax refund case came before the court for disposition on plaintiff's motion for summary judgment to determine whether foreign tax law concepts are controlling when computing indirect tax credits under section 902 of the Internal Revenue Code of 1954, 26 U.S.C. § 902 (1954), and in the alternative, whether the payments received by its foreign subsidiary from the British government during 1975 and 1976 were properly classified and treated as refunds for years 1970 and 1971 under section 905 of the Internal Revenue Code of 1954, 26 U.S.C. § 905 (1954). Defendant brought a cross-motion for summary judgment claiming that United States tax law con-

cepts are controlling for purposes of section 902 and that the Commissioner of Internal Revenue acted properly under section 905 when he directed that the section 902 indirect tax credits claimed by plaintiff on its 1970 and 1971 United States income tax returns be recomputed upon receipt of tax refunds in 1975 and 1976 by the foreign subsidiary for the years 1970 and 1971.

FACTS

In 1970 and 1971, Goodyear Tire & Rubber Company, Ltd. (Goodyear England), a Great Britain corporation and plaintiff's wholly owned subsidiary, operated at a profit and paid dividends to plaintiff.[1] During this time, Goodyear England was engaged in business in Great Britain and, to a small extent, in the Republic of Ireland. It conducted no business in the United States and, consequently, had no income subject directly to United States income taxes. Plaintiff, therefore, claimed foreign tax credits in 1970 and 1971 pursuant to section 902(a)(1) for British taxes deemed paid on the dividends by Goodyear England.[2]

In 1972, Goodyear England operated at a loss. This loss, recognized under both United States and British tax law, was carried back to 1971 and applied to reduce Goodyear England's 1971 accumulated profits. Because the

[1] The Goodyear Tire & Rubber Company is the parent of the consolidated group of United States corporations constituting the plaintiff.

[2] A condition for the credit is that the domestic corporation satisfy certain ownership requirements in the foreign corporation. The only such ownership requirement applicable here is that the United States parent corporation own at least ten percent of the voting stock of the foreign corporation. 26 U.S.C. § 902(a)(1) (1954). There is no dispute that plaintiff satisfies this requirement since Goodyear England is plaintiff's wholly owned subsidiary.

amount of the 1972 loss was known prior to the time Goodyear England paid its 1971 taxes, the dividend paid to plaintiff in 1971 was considered to have been paid out of Goodyear England's accumulated profits as reduced by both its 1972 loss and the 1971 taxes paid thereon.

In 1973, Goodyear England incurred another net operating loss. This loss, however, was attributable to two British tax deductions not allowable under United States tax law. The first permitted accelerated depreciation write-offs and the second permitted inventory reductions by the increase in inventory value less ten percent of trading profit for the year. Since 1972 was also a loss year, Goodyear England carried back its 1973 net operating loss in accordance with British tax law to both 1971, where it more than eliminated all accumulated profits, and 1970, where it substantially reduced accumulated profits. The British government subsequently made refund payments to Goodyear England during 1975 and 1976 amounting to £650,000 for the adjustment to its 1971 accumulated profits and £671,599 for the adjustment to its 1970 accumulated profits.

In 1980, as a consequence of the payments to Goodyear England by the British Government in 1975 and 1976, the Commissioner of Internal Revenue, asserting authority under section 905, recomputed the section 902(a)(1) tax credits claimed by plaintiff on its 1970 and 1971 United States income tax returns. The Commissioner converted Goodyear England's 1973 loss under British tax law to a profit of £1,137,152 in accordance with United States tax law which did not allow the accelerated depreciation or special inventory deductions permitted by Great Britain. On November 21, 1980, the Commissioner adjusted the foreign tax credits claimed by plaintiff in 1970 and 1971 and timely assessed the following deficiencies, plus interest

thereon, owed by plaintiff as a result of these new computations:

YEAR	TAX	INTEREST	TOTAL
1970	$323,654	$132,611.66	$456,265.66
1971	237,616	97,359.06	334,975.06
			791,240.72

Plaintiff subsequently paid the tax deficiencies to the Internal Revenue Service Center, Cincinnati, Ohio on December 3, 1980.

In November 1982, plaintiff filed timely refund claims with the IRS for the assessed deficiencies plus interest thereon. The Regional Commissioner of Internal Revenue issued a notice of disallowance of the refund claims on September 30, 1983. Plaintiff subsequently filed its Complaint in this court to recover $791,240.72 paid to IRS, plus interest thereon, as a result of the adjustments to its 1970 and 1971 United States income tax returns.

DISCUSSION

Summary judgment is appropriate when there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. RUSCC 56(c). In evaluating a motion for summary judgment, any doubt must be resolved in favor of the nonmoving party. *Housing Corp. v. United States,* 199 Ct. Cl. 705, 710, 468 F.2d 922, 924 (1972); *Campbell v. United States,* 2 Cl. Ct. 247, 249 (1983). In addition, the "inferences to be drawn from the . . . facts . . . must be viewed in the light most favorable to the party opposing the motion" for summary judgment. *Adickes v. S.H. Kress & Co.,* 398 U.S. 144, 158-59 (1970) (quoting *United States v. Diebold, Inc.,* 369 U.S. 654, 655 (1962)); *Ball v. United States,* 1 Cl. Ct. 180, 183

(1982). The court agrees with the parties that there are no genuine issues of material fact in dispute and that this case is properly before the court for disposition on cross-motions for summary judgment.

I. Application of Sections 901 and 902

Section 901(a) of the Internal Revenue Code of 1954, 26 U.S.C. § 901(a) (1954)[3], in accordance with section 901(b)(1) of the Internal Revenue Code of 1954, 26 U.S.C. § 901(b)(1) (1954)[4], permits domestic taxpayers to elect to receive a credit, within prescribed limits, for any foreign income tax paid, or deemed to have been paid, during the taxable year. Section 902(a)(1) prescribes the terms under which the deemed paid foreign tax credit is allowed and explains the manner in which this credit is to be computed. The statute provides in pertinent part:

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[3] The relevant part of the statute as in effect for the period here in controversy is as follows:

> (a) Allowance of Credit – If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall . . . be credited with the amounts provided in the applicable paragraphs of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. . . .

26 U.S.C. § 901(a) (1954).

[4] The relevant part of the statute as in effect for the period here in controversy is as follows:

> (b) Amount Allowed – Subject to the applicable limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):
>
> > (1) Citizens and domestic corporations – In the case of a . . . domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country. . . .

26 U.S.C. § 901(b)(1) (1954).

[a] domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall—

> (1) to the extent such dividends are paid by such foreign corporation out of accumulated profits (as defined in subsection (c)(1)(A)) of a year for which such foreign corporation is not a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country . . . on or with respect to such accumulated profits . . . which the amount of such dividends (determined without regard to Section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid). . . .

26 U.S.C. § 902(a)(1) (1954).

Section 902(a)(1) requires the deemed paid foreign tax credit claimed by a domestic corporation with regard to dividends received from a foreign subsidiary to be computed by multiplying the amount of foreign income tax the foreign subsidiary paid "on or with respect to" that years accumulated profits by a fraction. *Champion Int'l Corp. v. Commissioner of Internal Revenue,* 81 T.C. 424, 429 (1983); *H.H. Robertson Co. v. Commissioner of Internal Revenue,* 59 T.C. 53, 77 (1972), *aff'd,* per order, (3rd Cir. 1974). The numerator of the fraction is the dividend paid to the domestic corporation by the foreign subsidiary out of the foreign subsidiary's accumulated profits for the tax year. *Id.* The denominator of the fraction is the accumulated profits for the tax year minus the foreign tax paid by

the foreign subsidiary. *Id.*[5] Both parties in this case agree that the equation set forth by the court is the proper mathematical expression of section 902(a)(1).[6] The parties disagree, however, as to whether the denominator of this fraction, *i.e.,* accumulated profits of the foreign subsidiary minus the foreign income tax paid by the foreign subsidiary, must be computed under British or United States tax law.

Plaintiff contended that in computing its section 902(a)(1) tax credit for dividends received from Goodyear England during 1970 and 1971, the accumulated profits of Goodyear England must be computed in accordance with British tax law concepts so that each year's accumulated

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[5] Section 78 of the Internal Revenue Code of 1954, 26 U.S.C. § 78 (1954), requires that the amount of tax deemed paid by the domestic corporation be included in its gross income, a computation referred to as "grossing-up." When there is grossing-up, the denominator of the section 902 tax credit equation is equal to accumulated profits of foreign subsidiary without reduction for the amount of foreign tax paid by the foreign subsidiary on such profits. When there is no grossing-up, the denominator is equal to accumulated profits of foreign subsidiary minus the amount of foreign tax paid by the foreign subsidiary on such profits. Section 78 is not applicable, and therefore no grossing-up is required, when "any amount of United Kingdom income tax appropriate to a dividend paid by a corporation which is a resident of the United Kingdom . . . is included in the gross income of such domestic corporation in accordance with Article XIII of the income tax convention between the United States and the United Kingdom." Treas. Reg. § 1.78-1(c) (1965). The parties concur as to the appropriateness of the section 902 equation.

[6] Section 902(a)(1) may be expressed as the following mathematical equation:

$$\begin{array}{c}\text{Section 902}\\\text{Credit}\end{array} = \begin{array}{c}\text{Foreign Income}\\\text{Tax Paid by}\\\text{Foreign Subsidiary}\end{array} \times \frac{\begin{array}{c}\text{Dividends Received by}\\\text{Domestic Parent}\end{array}}{\begin{array}{c}\text{Accumulated Profits}\\\text{of Foreign Subsidiary minus}\\\text{Foreign Tax Paid}\end{array}}$$

profit is matched properly with the foreign tax imposed on those profits. Plaintiff argued that if British tax concepts are not followed, the British taxes imposed on Goodyear England will be matched with accumulated profits of a different year and result in double taxation. The defendant claimed, however, that United States tax law should be applied for foreign tax credit purposes because there is nothing set forth in either section 902(a)(1) or section 902(c)(1)(A) to indicate that the statutory term "accumulated profit" should be equated with foreign taxable income. Defendant claimed that "accumulated profit" refers instead to United States taxable income and requires a computation which is exactly the same as if the foreign subsidiary were itself a domestic corporation. Both parties cite *Champion International Corp. v. Commissioner,* 81 T.C. 424 (1983) and *Steel Improvement and Forge Co. v. Commissioner,* 36 T.C. 265 (1961), *rev'd on other grounds,* 314 F.2d 96 (6th Cir. 1963), for support. The court, recognizing the Tax Court's expertise in addressing the substantive questions of law presented by this case, will review the parties' contentions in light of these two Tax Court decisions prior to discussing the statutory language itself and its applicable legislative history and administrative interpretation.

In *Champion International,* a domestic corporation received a dividend from its Canadian subsidiary in 1971 and claimed a foreign tax credit pursuant to section 902. The subsidiary had operated at a profit in 1969 and 1971, but incurred a loss in 1970. The loss, recognized by both United States and Canadian tax law, was carried back to 1969 in accordance with Canadian carryback provisions resulting in a partial refund of Canadian taxes previously paid by the subsidiary for 1969. The Tax Court held that when computing the foreign tax credit for the 1971 dividend the foreign subsidiary's 1969 accumulated profits

were to be reduced by the amount of the loss carryback from 1970 for purposes of the denominator as well as the numerator of the fraction in the statutory formula.

Plaintiff in the case at bar contended that *Champion International* stands for the proposition that foreign tax law is controlling when computing the accumulated profits of a subsidiary and the subsequent amount of taxes deemed paid. Plaintiff's reliance is misplaced. Although the 1970 loss was carried back in accordance with foreign tax law, the threshold questions as to whether there was a loss, and the subsequent determination of the amount of the loss, were decided pursuant to United States tax law. *Champion International,* 81 T.C. at 433. Thus, the accumulated profits computed under United States tax law and the taxes paid by the subsidiary computed under Canadian tax law were both reduced as a result of the loss because both United States and Canadian tax law recognized the loss. *Id.* at 447.

In *Steel Improvement*[7] the taxpayer was a domestic corporation which in 1954 received a dividend from its wholly owned Canadian subsidiary. The subsidiary reported a taxable loss for 1954 in its Canadian tax return and carried the loss back to 1953 offsetting taxable income previously reported for that year and causing the taxes previously paid to be refunded. The loss, however, was caused by a special Canadian tax provision that would not have been an allowable deduction under United States tax law. In fact, applying United States tax law, the subsidiary actually sustained a profit for 1954.

[7] *Steel Improvement,* although reversed on other grounds, rendered the Tax Court's holding on the foreign tax credit issue meaningless so far as the rights of the parties to that case were concerned. It nevertheless represents sound analysis and is further illustrative of the complex relationship that exists between foreign losses and section 902 deemed paid foreign tax credits.

The Tax Court held in *Steel Improvement* that the taxpayer's deemed paid foreign tax credit must be adjusted to account for the refund of Canadian taxes to its subsidiary, in spite of the fact that the 1954 loss was not to be recognized for purposes of reducing the subsidiary's accumulated profits in the section 902 equation. *Steel Improvement,* 36 T.C. at 282. The court did not recognize the reduction in accumulated profits because the loss resulted from a special Canadian accelerated depreciation allowance that was not an allowable deduction under United States tax law. *Id.* at 277. As the court explained in *Champion International*:

> In *Steel Improvement & Forge Co.,* the carryback of the loss did not affect the accumulated profits of the carryback year or the determination of what year's accumulated profits were the source of the dividend therein concerned. This is because the loss was caused by a deduction not recognized by U.S. law. Therefore, although the loss eliminated the Canadian *tax* of both the loss year and the carryback year, it left the *accumulated profits* of those years unaffected. Accumulated profits are determined under American law rather than foreign law.

Champion International, 81 T.C. at 447 (emphasis in original).

In the case at bar, the 1972 loss sustained by Goodyear England was recognized by both United States and British tax law and, as a result, operated to reduce both Goodyear England's accumulated profits and its tax liability for 1972 and 1971, the carryback years, as in *Champion International.* The 1973 loss, however, was not recognized under United States tax law. Thus, although the loss reduced Goodyear England's tax liability under British tax law for 1973, 1971 and 1970, the carryback years, it should leave

the accumulated profits of those years intact for purposes of the Section 902 indirect tax credit computation, as in *Steel Improvement.* The court, therefore, concludes that defendant correctly adjusted Goodyear England's 1973 profits to correspond with United States tax law. The court does not hold, however, that accumulated profit is in all cases equivalent to United States earnings and profits and should be computed exactly as if the foreign subsidiary were itself a domestic corporation. Such a conclusion must be arrived at independently on a case by case basis given the complexities inherent in the applicable code provisions and in order to reach the underlying purposes Congress had in mind when enacting the indirect tax credit legislation.

A. The Statutory Framework

It is axiomatic that in determining the meaning of a statute, the inquiry must first be directed to the statutory language itself and, if the language is unambiguous, the duty of interpretation does not arise. *American Tobacco Co. v. Patterson,* 456 U.S. 63, 68 (1982); *Flora v. United States,* 357 U.S. 63, 65 (1958); *Caminetti v. United States,* 242 U.S. 470, 485 (1917); *Lykes Bros. S.S. Co., Inc. v. United States,* 206 Ct. Cl. 354, 356, 513 F.2d 1342, 1349 (1975); *United Am. Ins. Co. v. United States,* 201 Ct. Cl. 32, 33, 475 F.2d 612, 614 (1973); *Freese v. United States,* 6 Cl. Ct. 1, 17 (1984), *aff'd mem.,* 770 F.2d 177 (Fed. Cir. 1985); *J. H. Miles & Co., v. United States,* 3 Cl. Ct. 10, 13 (1983). In such circumstances, the court is limited to enforcing the statute according to its expressed terms.

Section 902(c)(1)(A) defines "accumulated profits" for purposes of the indirect foreign tax credit as follows:

> (1) Accumulated profits defined. – For purposes of this section, the term 'accumulated profits' means

> with respect to any foreign corporation—(A) for purposes of subsections (a)(1), (b)(1)(A), and (b)(2)(A), the amount of its gains, profits or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country. . . .
>
> * * * * *
>
> The secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years . . . and in other respects treating dividends as having been paid from the most recently accumulated gains, profits or earnings.

26 U.S.C. § 902(c)(1)(A) (1954). In addition, section 902(a)(1) provides that, to the extent a qualifying domestic corporation receives dividends which are paid by a foreign corporation out of accumulated profits, the domestic corporation shall be deemed to have paid the same proportion of foreign taxes paid "on or with respect to such accumulated profits, which the amount of such dividends . . . bears to the amount of such accumulated profits in excess of such income, war profits and excess profits taxes. . . ." 26 U.S.C. § 902(a)(1) (1954).

The repeated reference to "such accumulated profits" demands that the meaning assigned to the term be consistent throughout the section 902 indirect tax credit formula. *Champion Int'l Corp. v. Commissioner of Internal Revenue,* 81 T.C. 424, 435 (1983). Both parties in the present case agree that United States tax law governs the definition of the numerator, that is, whether a distribution of property by a foreign subsidiary to a domestic parent

corporation is a dividend or a return of capital. *Untermyer v. Commissioner of Internal Revenue,* 24 B.T.A. 906 (1931), *aff'd,* 59 F.2d 1004 (2d Cir.), *cert. denied,* 287 U.S. 647 (1932). United States tax law also governs what foreign taxes qualify as income taxes for indirect tax credit purposes. *Keasbey & Mattison Co. v. Rothensies,* 133 F.2d 894 (3rd Cir.), *cert. denied,* 320 U.S. 739 (1943). Accumulated profits in the denominator of the indirect tax credit equation represent the fund from which dividends in the numerator of the equation are paid. Algebraic consistency requires that United States tax law similarly govern the computation of the foreign subsidiary's accumulated profits, *i.e.,* the fund from which the dividends are paid and the amount upon which the tax is based. According to two commentators who have written extensively on the indirect credit:

> After all the profits of a year have been distributed, the quantity used in the numerator of the fraction, dividends, must be the same as the amount used in the denominator, net profits. Otherwise, the amount of indirect credit will be either more or less than the amount of the foreign tax actually paid. In short, the section 902 allocation fraction functions properly only when the definition of dividends (aggregate) and net profits is exactly the same.

1 E. Owens & G. Ball, *The Indirect Credit* 162 (1975). The statute itself is silent, however, as to whether accumulated profits are to be computed in accordance with United States or foreign tax law. Thus, in this area of law fraught with complex definitional concepts, the court cannot look only to the express language of the statute. *Champion Internat'l,* 81 T.C. at 436. *See also, Associated Telephone & Telegraph Co. v. United States,* 306 F.2d 824, 832 (2d Cir. 1962) (a court must consider the policies behind the foreign tax credit generally rather than terminology itself).

Lack of clarity in statutory language requires a court to instead "find that interpretation which can most fairly be said to be embedded in the statute, in the sense of being most harmonious with its cheme and with the general purposes that Congress manifested." *NLRB v. Lion Oil Co.*, 352 U.S. 282, 297 (1957); *see also Bailey v. United States*, 206 Ct. Cl. 169, 178, 511 F.2d 540, 546 (1975); *Aking v. United States*, 194 Ct. Cl. 477, 483, 439 F.2d 175, 177 (1971); *Conlon v. United States*, 8 Cl. Ct. 30, 33 (1985); *Witco Chemical Corp. v. United States*, 2 Cl. Ct. 504, 507 (1983), *aff'd*, 742 F.2d 615 (Fed. Cir. 1984). When statutory language is nebulous, literal interpretation will be eschewed in favor of a more flexible inquiry into legislative intent, *Texas State Comm'n for the Blind v. United States*, 6 Cl. Ct. 730, 738 (1984), and into regulations promulgated by the administrative agency entrusted with the obligation of enforcing the statute. *Sohio Transp. Co. v. United States*, 5 Cl. Ct. 620, 629 (1984), *aff'd*, 766 F.2d 499 (Fed. Cir. 1985).

B. The Legislative History

In enacting section 238(e) of the Internal Revenue Act of 1921, the predecessor of section 902, Congress stated:

> In such a case a foreign subsidiary is much like a foreign branch of an American corporation. If the American corporation owned a foreign branch, it would include the earnings or profits of such branch in its total income, but it would also be entitled to deduct from the tax based upon such income any income or profits taxes paid to foreign countries by the branch in question. Without special legislation however, no credit can be obtained where the branch is incorporated under foreign laws.

> Since the foreign subsidiary may not send back to the American parent company all of its profits or earnings, it follows that the American parent company should not obtain a credit for all the income and profits taxes paid to foreign countries. The amendment in question grants only a partial or prorated credit.

61 Cong. Rec. 7184 (1921). Where congress adopts a new law incorporating a prior law, Congress can be presumed to acquiesce in the purpose of the incorporated law. *Seaboard Air Line R. Co. v. United States*, 113 Ct. Cl. 437, 447, 83 F.Supp. 1012, 1015, *cert. denied*, 338 U.S. 848 (1949); *Massachusetts Mut. Life Ins. Co. v. United States*, 5 Cl. Ct. 581 (1984), *aff'd*, 761 F.2d 666 (Fed. Cir. 1985). There are three principal purposes of the indirect tax credit provisions, *i.e.*, to treat foreign subsidiaries and foreign branches of domestic corporations similarly, to eliminate double taxation and to limit the amount of foreign credit a domestic corporation is permitted to claim with respect to foreign taxes paid by its foreign subsidiary. The court's holding that United States tax law concepts must be applied to adjust the foreign subsidiary's profits for purposes of section 902 effectuates congressional intent.

Defendant did not recognize Goodyear England's 1973 loss carryback of £3,375,375 and instead converted the loss to a profit of £1,137,152 since United States tax law did not allow the two British deductions which precipitated the loss. Defendant then adjusted Goodyear England's accumulated profits for 1970 and 1971 to £3,812,467 and £3,224,486 respectively and recomputed plaintiff's tax credit to equal £235,038 in 1970 and £12,086 in 1971. The Commissioner further determined that since United States tax law did not recognize Goodyear England's claimed 1973 British tax loss, the denominator of the section 902 tax credit equation still exceeded the

stipulated dividends in the numerator. Thus, contrary to plaintiff's computations and sourcing arguments, there was no need to proportion the dividends received by plaintiff in 1970 and 1971 to accumulated profits of other previous years.

Contrary to plaintiff's contention, the above computations do not result in double taxation. It is true that the foreign subsidiary, pursuant to British tax law, claimed a loss in 1973 which it was permitted to carry back to reduce its profits for 1970 and 1971. When determining a section 902 credit for a domestic parent, however, the foreign subsidiary's profits must be adjusted in accordance with United States tax law. *Champion International*, 81 T.C. at 447. The parties have stipulated that all adjustments made by the Commissioner were proper under United States tax law and that the two British deductions which resulted in the 1973 loss were not allowable deductions under United States tax law. The adjustments were, therefore, proper and double taxation is avoided because the profits from which the dividends were paid in 1970 and 1971 were not reduced by the amount of the loss and, in addition, the subsidiary incurred no tax liability on these profits as a result of the tax refunds. However, the refund of 1970 and 1971 taxes to the subsidiary must still be accounted for when computing the section 902 credit to ensure that credit given to the domestic parent accurately reflects taxes actually paid by its foreign subsidiary. *Id.* In the case at bar, the subsidiary paid no taxes for 1970 and 1971 as a result of the refunds it received during 1975 and 1976. To not recognize this fact as plaintiff urges would eviscerate the very purpose of the pro-rata credit and permit plaintiff a substantial windfall in avoiding other taxes with the phantom taxes deemed paid.

Permitting plaintiff to take advantage of this windfall would also detract from treating foreign branches and

foreign subsidiaries similarly for purposes of the section 902 credit. In its General Statement adopting the Revenue Act of 1962, which amended both section 78 and section 902, the Senate stated:

> The remaining provisions in the bill (which included sections 78 and 902) are concerned primarily with improving tax equity and eliminating tax evasion and avoidance, either in the domestic economy or with respect to income earned abroad by American interests. In the latter case, the primary concern . . . has been with the removal of special tax advantages accruing to 'tax havens.'

S. Rep. No. 1881, 87th Cong., 2d Sess. 1, *reprinted in* 1962 U.S. Code Cong. & Admin. News 3304. Absent the amendments to section 78 by the Revenue Act of 1962, the entire income of a foreign branch would be treated as taxable income by both the United States and the foreign country, while only the distributed after-tax income of a foreign subsidiary would be treated as taxable income by the United States. Treating the foreign subsidiary in the instant case similarly to a foreign branch eliminates tax evasion and avoidance accruing to the foreign corporate "tax haven" without subjecting the subsidiary to double taxation.

C. Administrative Interpretation

Treasury Regulation 1.902-3(c)(1) states that "[a]ccumulated profits for any taxable year of a first-tier corporation which is not a less developed country corporation . . . shall . . . be the sum of (i) the earnings and profits of such corporation for such year, and (ii) the foreign income taxes imposed on or with respect to the gains, profits and income to which such earnings and profits are attributable." 26 C.F.R. § 1.902-3(c)(1) (1965). This regulation clearly distinguishes "earnings and profits"

from "gains, profits and income." The relation of "gains, profits and income" to foreign income taxes indicates this tax concept is to be equated with foreign taxable income. "Earnings and profits," on the other hand, appear in this instance to refer to income which would be subject to United States tax. *Cf. Champion Int'l*, 81 T.C. at 447.[8] This regulation is an attempt to recoup, for purposes of section 902, income that would otherwise escape taxation in both the foreign country and the United States. The regulation is consistent with the purposes enunciated by Congress when enacting the indirect tax credit legislation and further supports the court's decision.

II. Application of Section 905

Plaintiff contended that in the event United States tax law concepts are deemed to be controlling for purposes of section 902, the payments from the British government to the foreign subsidiary during 1975 and 1976 were not the type of payments referred to as refunds in section 905 and

[8] Computing "earnings and profits" in accordance with United States tax law in this instance dispels the plaintiff's "sourcing" arguments and preserves the Tax Court's ruling in *H. H. Robertson Co. v. Commissioner of Internal Revenue*, 59 T.C. 53 (1972), *aff'd by memorandum*, 500 F.2d 1399 (3rd Cir. 1984), that accumulated profits is an annual computation while earnings and profits is an aggregate computation of a corporation's undistributed realized profits. Although earnings and profits is an aggregate concept, for foreign tax credit purposes it is, in effect, an annual computation since the regulation mandates only those earnings and profits attributable to foreign taxable income for the given year are to be considered when computing the indirect foreign tax credit. Thus, although a foreign subsidiary's accumulated profits initially has as its basis a computation based on earnings and profits, adjustments required by the regulation apportion this aggregate amount to the particular year(s) in question making the initial aggregate computation ultimately an annual computation.

are, therefore, not within the reach of the Commission's 905 recomputation powers. Plaintiff argued that since the language of the section 905 has not changed from that of its predecessor, section 252 of the Revenue Act of 1918, the term "refund" must be interpreted consistently with its original meanings, *i.e.*, the term applies only to refunds of incorrect foreign taxes and the subsequent event of a net operating loss does not disturb an earlier credit granted for a foreign tax which was correct when paid. Thus, according to plaintiff, the Commissioner of Internal Revenue acted without authority when he directed the section 902(a)(1) tax credits claimed by plaintiff on its 1970 and 1971 United States income tax returns be recomputed. Plaintiff's reasoning, however, is inapposite with both the expressed language of the statute and rules of statutory interpretation.

The plain and unambiguous language of section 905(c) states that "if any tax paid is refunded in whole or part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected." 26 U.S.C. S 905(c). The duty of interpretation does not arise when statutory language is unambiguous. *E.g., American Tobacco Co. v. Patterson*, 456 U.S. 63, 68 (1982). In such cases, words in the statute are considered to be used in their ordinary and usual sense. *Old Colony R.R. Co. v. Commissioner of Internal Revenue*, 284 U.S. 552, 560 (1932); *Hine v. United States*, 113 F.Supp. 340, 343, 125 Ct. Cl. 836, 841 (1953); *Fordyce v. United States*, 7 Cl. Ct. 591, 596 (1985). The court agrees with defendant that the reason for the refund is immaterial. What is significant is that a tax refund was paid to, and received by, plaintiff's subsidiary. The statutory term "refund" when construed in its ordinary and usual sense includes repayment of tax dollars stemming from a subsequent net operating loss. The court would be hard-

pressed to find any repayment of tax dollars to not be a refund as the term is used. Indeed, to hold as plaintiff urged, that Congress must be held to assent only to those definitions afforded to a term at the term the original statute incorporating that term was enacted, would produce results contrary to the unmistakable purposes Congress had in mind when enacting the indirect tax credit legislation.

As the court previously discussed, permitting plaintiff an indirect tax credit for taxes its foreign subsidiary did not in fact pay would go well beyond the legislation's purpose of preventing double taxation and would frustrate the purposes of treating a foreign subsidiary similary to a foreign branch of a domestic corporation and limiting the amount of foreign tax credit a domestic corporation is permitted to claim. The court holds instead that the payments to Goodyear England during 1975 and 1976 were refunds as that term is used in section 905 and, therefore, the Commissioner of Internal Revenue did act properly when he directed the section 902(a)(1) credits claimed by plaintiff on its 1970 and 1971 United States income tax returns be recomputed.

CONCLUSION

For the foregoing reasons, the court finds that plaintiff is entitled to no tax refund as a result of the recomputations to its 1970 and 1971 United States income taxes ordered by the Commissioner of Internal Revenue. Plaintiff's motion for summary judgment is denied and defendant's motion for summary judgment is granted. The Clerk is ordered to enter judgment in favor of defendant and to dismiss the complaint.

IT IS SO ORDERED.

/s/ M. R. Tidwell
MOODY R. TIDWELL
Judge

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 88-1201

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES,
PLAINTIFF-APPELLANT

v.

THE UNITED STATES, DEFENDANT-APPELLEE

[Entered Aug. 31, 1988]

Judgment

ON APPEALS from the United States Claims Court in Case No(s). 510-85 T

This CAUSE having been heard and considered, it is ORDERED AND ADJUDGED:

REVERSED

ENTERED BY ORDER
OF THE COURT

AUG 31, 1988 /s/ FRANCIS X. GINDHART
Francis X. Gindhart, Clerk

ISSUED AS A MANDATE: NOV. 15, 1988

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 88-1201

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, PLAINTIFF-APPELLANT

v.

THE UNITED STATES, DEFENDANT-APPELLEE

[Filed Dec. 28, 1988]

Order

A suggestion for rehearing in banc having been filed in this case, and a re[s]ponse thereto having been invited by the court and filed,

UPON CONSIDERATION THEREOF, it is

ORDERED that the suggestion for rehearing in banc be, and the same is, declined

Judge Archer would rehear the case in banc.

FOR THE COURT

December 28, 1988 /s/ FRANCIS X. GINDHART
Francis X. Gindhart, Clerk

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 88-1201

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, PLAINTIFF-APPELLANT

v.

THE UNITED STATES, DEFENDANT-APPELLEE

Before NEWMAN and BISSELL, Circuit Judges and RE, Chief Judge.*

[Filed Nov. 10, 1988]

Order

A petition for rehearing having been filed in this case,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and same hereby is, denied.

The suggestion for rehearing in banc is under consideration.

FOR THE COURT

11/8/88 /s/ FRANCIS X. GINDHART
Francis X. Gindhart, Clerk

* The Honorable Edward D. Re, Chief Judge, U.S. Court of International Trade, sitting by designation pursuant to 28 U.S.C. § 293(a).

APPENDIX F

The Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the years 1970 and 1971, provided in pertinent part:

§ 316. Dividend defined.

(a) General rule.

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

§ 901. Taxes of foreign countries and of possessions of United States.

(a) Allowance of credit.

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the applicable limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against the tax imposed by section 56 (relating

to minimum tax for tax preferences), against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1333 (relating to war loss recoveries) or under section 1351 (relating to recoveries of foreign expropriation losses), or against the personal holding company tax imposed by section 541.

(b) Amount allowed.

Subject to the applicable limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations.

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; * * *

§ 902. Credit for corporation stockholder in foreign corporation.

(a) Treatment of taxes paid by foreign corporation.

For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall—

(1) to the extent such dividends are paid by such foreign corporation out of accumulated profits (as defined in subsection (c)(1)(A)) of a year for which such foreign corporation is not a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any pos-

session of the United States on or with respect to such accumulated profits, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid); * * *

* * * * *

(c) Applicable rules.

(1) Accumulated profits defined.

For purposes of this section, the term "accumulated profits" means with respect to any foreign corporation—

(A) for purposes of subsections (a)(1), (b)(1)(A), and (b)(2)(A), the amount of its gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country or any possession of the United States; and

* * * * *

The Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

The Treasury Regulations on Income Tax (26 C.F.R.), as in effect in 1970 and 1971, provided in pertinent part:

§ 1.902-3 Credit for domestic corporate shareholder of a foreign corporation (after amendment by Revenue Act of 1962).

* * * * *

(c) Determination of accumulated profits and taxes paid on or with respect thereto—(1) First-tier corporation which is not a less developed country corporation. The accumulated profits for any taxable year of a first-tier corporation which is not a less developed country corporation, as defined in § 1.902-4, for such year shall in accordance with section 902(c)(1)(A), be the sum of—

(i) The earnings and profits of such corporation for such year, and

(ii) The foreign income taxes imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable.

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No. 88-1474

IN THE

Supreme Court of the United States

October Term, 1988

UNITED STATES OF AMERICA,
Petitioner,

vs.

THE GOODYEAR TIRE & RUBBER
COMPANY AND AFFILIATES,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether, in determining the source of a dividend paid out of a foreign subsidiary's profit previously taxed by a foreign country, the term "accumulated profits," for the purpose of the foreign tax credit provision of section 902 of the Internal Revenue Code,* refers to the amount of the gains, profits or income of the foreign subsidiary on or with respect to which the foreign tax was imposed, or refers to the amount of the income on which U.S. income tax would have been imposed if the foreign subsidiary had been subject to U.S. income tax.

The Respondent has restated the question to make it plain that the question presented involves associating the profit which is the source of the dividend with the foreign tax imposed on that profit for which the credit is claimed.

* Unless otherwise noted, citations to the Internal Revenue Code and "section" references herein are to the Internal Revenue Code of 1954 as in effect in 1970 and 1971 or to the sections thereof, as the case may be.

RULE 28.1 LIST OF AFFILIATES

The Goodyear Tire & Rubber Company has no affiliates other than wholly owned subsidiaries and the following:

Foreign Subsidiaries in Which the Parent Owns the Majority and the Minority Is Publicly Traded

Goodyear Canada Inc

Goodyear India Ltd

Goodyear Jamaica Ltd

Goodyear Thailand Ltd

PT Goodyear Indonesia

Gran Industria de Neumaticos Centroamericana SA

Foreign Subsidiaries in Which the Parent Owns the Majority and the Minority Is Privately Held

Goodyear Lastikleri TAS

Goodyear Malaysia Berhael

Goodyear Maroc SA

Goodyear Taiwan Ltd

The Goodyear Tire & Rubber Company of the Philippines Ltd

Second and Third Tier Foreign Subsidiaries Which Are Owned through Foreign Subsidiaries

These include a great many small corporations, principally tire stores and chains of tire stores in which the balance of the stock is generally privately held.

Domestic Subsidiaries

Brad Ragan, Inc.: part of the minority interest is traded on the American Stock Exchange, 74.6% owned by parent

Hayes Construction Tire Service Inc: 51% owned by Brad Ragan Inc, the balance privately held

Domestic Corporations Less Than 50% Owned and Balance Is Privately Held

Sam's Tire

Waste Recovery, Inc

IGEN, Inc

Partnership and Joint Venture Participation by Parent

Renaissance Center, Detroit: 1.27%

Sixth Floor Associates: 25%

F & M Co Limited Partnership: 22.5%

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

The Respondent, The Goodyear Tire & Rubber Company and Affiliates, respectfully requests that this Court deny the Petition for a Writ of Certiorari seeking review of the opinion of the United States Court of Appeals for the Federal Circuit in this case. The opinion of the Federal Circuit is reported at 856 F.2d 170. The opinion of the United States Claims Court is reported at 14 Cl. Ct. 23. The opinions are reproduced in Appendices A and B to the Petition, and they have not been reproduced again in this Brief in Opposition.

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves sections 902, 904(a) and 905(c) of the Internal Revenue Code of 1954 (26 U.S.C. §§902, 904(a) and 905(c)) and section 1.902-3(c)(1) and (4) of the Treasury Regulations (26 C.F.R. §1.902-3(c)(1) and (4) (1965)), as in effect for 1970 and 1971. Sections 904(a) and 905(c) of the Internal Revenue Code of 1954 and section 1.902-3(c)(4) of the Treasury Regulations are set forth below in pertinent part in an appendix. Resp. App., *infra* pp. A1-A4. The remaining statutory and regulatory provisions are set forth in Appendix F to the Petition. Pet. App. at pp. 32a-35a.

STATEMENT OF THE CASE

All of the facts in this case were included in a stipulation with numerous exhibits. Two of the exhibits have been attached as an appendix to this Brief in Opposition because they set out in schedules the opposing calculations of the foreign tax credit by the parties, and may therefore be of assistance to this Court in understanding the unusual and complicated problem presented here. Resp. App., *infra* pp. A5 & A7.

The Respondent does not disagree with the basic facts presented in Petitioner's Statement. It does take issue with the analysis and conclusions contained in the Statement in a number of respects, particularly the following:

1. The formula on page 3 of the Petition is not the formula for the foreign tax credit but rather the formula for the "foreign tax deemed paid." The actual foreign tax credit is derived by use of this formula after applying the "sourcing" principles discussed below and then applying the limitations on the credit contained in section 904. The difference is critical to the resolution of the issue in the instant case.

2. The Petition glosses over one of the most important aspects of this case. This case involves the principle of "sourcing" of dividends among several years. Petitioner relegates this entire subject to a footnote (Pet. at p. 4 n.3), but it must be explained if this case is to be understood.

At first thought it might be supposed that the formula set out on page 3 of the Petition is to be applied by inserting as P the entire undistributed surplus of the foreign corporation, and inserting as T all the foreign taxes ever paid by that corporation not previously

recovered as credits. But in *General Foods Corp. v. Commissioner,* 4 T.C. 209 (1944), *acq.* 1946 C.B. 2, the Tax Court held (and this is now well-settled) that the dividend is to be allocated among the years in which the foreign corporation earned the profit out of which that dividend was paid, and the "tax deemed paid" (TD/P) is to be computed separately for each such year, P being the after-tax profit of a given year, T being the foreign tax on the year's profit, and D being the dividend paid *out of* that year's profit whether or not paid *in* that year. The court said:

> To properly give effect to the language of the [statute], it is necessary to relate the tax credit to the particular year or years in which the accumulated profits (from which the dividends were paid) were earned and taxed. 4 T.C. at 216.

It necessarily follows that if the total dividend exceeds the "accumulated profits" after tax of the current year, then the excess part of the dividend is deemed paid out of the "accumulated profits" after tax of the preceding year. In such a case the tax "with respect to the accumulated profits," in the words of section 902, includes the tax paid on that part of the dividend that is attributable to the profit of the preceding year. This is the principle known as "sourcing" the dividend to several years.

The concept of "sourcing" in effect requires segregating the foreign subsidiary's profit—its "accumulated profits" before tax—by years. It is as if each year's profit is put in one of a row of pigeonholes in an old-fashioned desk. The corresponding foreign tax is allocated to the corresponding one of a parallel row of annual tax pigeonholes. To find the numbers for the formula in section 902, the dividend is first assigned to the pigeonhole for the year in which it was paid. Section

902(c)(1). If there is enough profit there to cover the dividend, we simply determine the fraction D/P by dividing the dividend by the profit. This fraction is multiplied by the tax in the corresponding pigeonhole for the same year to determine the "tax deemed paid."

If, on the other hand, the total dividend paid exhausts the profit for the year to which it was initially assigned, the rest of the dividend takes some of the profit from the pigeonhole for the next preceding year. The "tax deemed paid" will be calculated by application of the formula to each year separately. The amounts so calculated are then added, and the aggregate is subjected to the limitations of section 904 to determine the foreign tax credit. Thus, the "tax deemed paid" will be all of the tax corresponding to the first pigeonhole and part of the tax proportionate to any profit allocated to a pigeonhole for a previous year.

In applying the formula for each year, T, the tax for the year, is the amount of tax actually imposed for that year by the foreign government; the United States is not at liberty to move T to another year or change its amount. The determination of D for each year depends on the "accumulated profits" for that year, since the dividend is allocated according to the profits available for paying it. It is essential therefore to determine the "accumulated profits" for each year so as to match it with the tax actually paid for that year, as required by the Internal Revenue Code. If the "accumulated profit" is not correctly matched with the tax, we can have a year when there appears to be profit but no foreign tax and another where there appears to be foreign tax but no profit.

It is most important to recognize that the identification of "accumulated profit" that is disputed here relates to the profit of the foreign corporation that

must be allocated to appropriate pigeonholes to pair it with the foreign tax appropriate to it. It does not relate to the U.S. income of the U.S. parent. This point bears on the Petitioner's statement that certain deductions permitted by British tax law "are not allowed in computing income under the Internal Revenue Code." Pet. at p. 5. Whether they would be allowed in computing U.S. taxable income of a U.S. taxpayer is not at issue here. The issue here is whether they were allowable in computing the income of a British corporation in determining the "source" of a dividend. The foreign corporation is not subject to the U.S. Internal Revenue Code.

This entire case turns, then, on a point not made clear in the Petition, which is how the "accumulated profits" after tax shall be allocated among the years. The Respondent asserts that the Internal Revenue Code requires that we leave that profit in the year where the foreign government found it and taxed it. If we move it to a different year—a different pigeonhole—it will no longer be paired with the corresponding tax. The Respondent therefore contends that the determination of "accumulated profits" for this purpose must be made in accordance with British law. The Petitioner contends that the allocation should be made as if the subsidiary were a U.S. taxpayer, recomputing the British income according to U.S. tax law.

Another way of phrasing this issue is to contrast two terms: "earnings and profits" and "accumulated profits."

"Earnings and profits" is a term used frequently in the Internal Revenue Code, but always in connection with determining the income of a corporation subject to U.S. tax. It may be used in an aggregate sense, rather like "undistributed surplus," or occasionally to refer to the undistributed earnings of a single year.

"Accumulated profits," on the other hand, is used in the Internal Revenue Code only for the purposes of the formula set out in section 902; and it is used only with reference to "sourcing" the profits of a foreign corporation. And despite its name, it does not represent an aggregate, but relates to a single year only.

Another term that is used in section 902 is "gains, profits and income," which, as even the Claims Court recognized (Pet. App. at pp. 25a-26a), refers to the foreign computation of income on which the foreign tax was imposed.

In terms of these contrasting concepts, the question here is whether they mean the same thing: does "accumulated profits" equal "earnings and profits" or does it equal "gains, profit and income" (the foreign income)?

The question, then, is whether "accumulated profits" relates to the subsidiary's "gains, profits and income" on which the foreign tax was imposed, or on what would have been the subsidiary's income if it had been a U.S. taxpayer.

It can be shown that whenever in the "tax deemed paid" computation "accumulated profits" departs from the foreign computation of income, distortion of the credit results, one way or the other. The Tax Court saw this in *Champion International Corp. v. Commissioner*, 81 T.C. 424 (1983); the Court of Appeals saw it here.

3. Section 3 of the Petitioner's Statement purports to be a summary of the opinion of the Claims Court but really is part of an argument by the Petitioner on the merits. It does not seem appropriate here to discuss the opinion of the Claims Court, which seems in any event to have mistaken the stipulated facts, but some reference to it will be made below. *See infra* pp. 14-16.

REASONS FOR DENYING THE PETITION

1. No conflict between courts of appeals for different circuits exists, and the Petitioner does not even argue the contrary. In fact only two other cases have arisen which were clearly in point. The first was *Pacific Gamble Robinson Co. v. United States,* 62-1 U.S.T.C. ¶9160 (W.D. Wash. 1961), an unpublished District Court opinion supporting the Petitioner's position. In the second, the Tax Court in *Champion International* decided the same issue in favor of Respondent's position and expressly refused to follow *Pacific Gamble Robinson.* 81 T.C. at 443-44 n.29. The Petitioner has not relied on *Pacific Gamble Robinson* here or below. It is mentioned here in the interest of candor, but it does not appear to be good authority today. Moreover, the Commissioner did not choose to appeal the *Champion International* case and initially announced his acquiescence in it. 1984-2 C.B. 1. He partially withdrew his acquiescence only while this case was pending. Rev. Rul. 87-72, 1987-2 C.B. 170.

2. The Court of Appeals in the present case has not "decided an important question of federal law which has not been, but should be, settled by this Court."

A. The portion of the Internal Revenue Code which gave rise to the present controversy was repealed three years ago. To compute the foreign tax credit under the Tax Reform Act of 1986, the previously undistributed income earned after 1986 is pooled, and all post-1986 taxes not already recovered as credits are also pooled (the position taken unsuccessfully by the taxpayer in the *General Foods* case). Thus it will no longer matter whether profits of past years are attributed to one year or another, and it will not be necessary to pair foreign profits earned after 1986 with the right foreign tax by

"sourcing." Accordingly, the term "accumulated profits" will no longer be used in referring to income subjected to post-1986 foreign taxes.

In view of this change in the law it is very hard to imagine that this issue can be very important in the future.

B. There is no reason to suppose that enormous amounts of money are at stake. There is nothing whatever in the record to show what amounts, if any, may be involved. Even if claims for the amounts now asserted by the Petitioner have been filed, who can say whether they were correctly computed by those who filed them? This argument should await the arrival of reality.

Measuring "gains, profits or income" of the foreign corporation by its own tax law instead of the law of its shareholders ought, in the nature of things, to produce as many increases in the U.S. revenue as decreases. And the application of the limits on credits under section 904 should reduce the loss to the Treasury while leaving the gains undiminished.

C. Compliance with the decision below will not unduly burden the Internal Revenue Service administratively. On the contrary, if the foreign corporation has settled its tax liability to the foreign government, the final determination of the amount of income subjected to tax under foreign law should make the determination of the credit a mere matter of computation under section 902.

Section 905(c) seems to confirm this conclusion. Under that section if the foreign government adjusts its tax, the U.S. shareholder reports the adjustment and the

credit is recomputed. Any increase in U.S. tax liability is then "assessed." Notwithstanding the statement on page 5 of the Petition, the Commissioner did not assert "deficiencies in respondent's income tax." To assert a deficiency would invoke administrative procedures under the Internal Revenue Code, culminating in a "Notice of Deficiency" and the option of filing a petition in the Tax Court. Respondent did not have that option under section 905(c); the tax was simply assessed, requiring Respondent to pay it, claim a refund, and sue in a District Court or the Claims Court. The reason for the difference in procedure is obvious: the essential facts are settled in the foreign proceeding, and the U.S. foreign tax credit is merely "recomputed," a simple perfunctory procedure.

On the other hand, if the income of each foreign corporation having U.S. shareholders entitled to a foreign tax credit is to be redetermined on U.S. principles, the Commissioner will have to audit every one of those foreign corporations. If disputes arise on audit, how will they be resolved? Will the foreign corporation send representatives to the United States to litigate its income under U.S. law? What court will have jurisdiction? Or will each 10% shareholder claiming a credit file his own case? Congress will have to enact new procedures to settle these questions.

The only simple solution is to let U.S. law govern the income of U.S. taxpayers, but to let foreign income of foreign corporations be "sourced" under the same law that imposed the foreign taxes on it. This does not require U.S. agents to conduct audits under foreign law. On the contrary, the Internal Revenue Service merely follows the foreign country's determination of what foreign tax was imposed on what year's income.

D. The decision below does not overturn any long-established administrative practice. In attributing such an effect to the decision, the Petitioner relies on these rulings:

I.T. 2676, XII-I C.B. 48, (1933). The language quoted by the Petitioner at page 10 merely requires that all income be included in the computation whether or not taxed by the foreign country, but it does not say that computations such as the amount and timing of income, depreciation, inventories, etc. are to be taken into account as if U.S. rules applied; in fact the ruling talks about the "distributable income or surplus" of the foreign corporation, and suggests, if anything, a corporate surplus such as British accountants would determine. The ruling clearly fails to establish a practice of applying U.S. tax principles.

Rev. Rul. 63-6, 1963-1 C.B. 126. This ruling does indeed assert that U.S. rules should govern the determination of "accumulated profits." But the Petitioner fails to note that in 1972 the Commissioner announced that this ruling was now obsolete. Rev. Rul. 72-621, 1972-2 C.B. 651.

Rev. Rul. 87-72, 1987-2 C.B. 170. This ruling relates to *Champion International*. It partially withdrew the acquiescence in that case. The *Champion International* case essentially supports Respondent's argument. In 1984 the Commissioner had announced his general acquiescence in *Champion International*. But in September 1985 Respondent filed the present action in the Claims Court, and in April 1987 it filed its Motion for Summary Judgment. Then on August 3, 1987 the Commissioner issued Rev. Rul. 87-72, which appears to be an attempt to limit his acquiescence in *Champion International* so as to leave room for his contrary

position in the present case. This action by the Commissioner merely confirms the fact that the *Champion International* case really supports Respondent.

Rev. Rul. 87-14, 1987-1 C.B. 181. This ruling is similarly self serving.

One point does seem clear: the Commissioner's position when he withdrew his 1963 ruling and when he acquiesced in the *Champion International* case was contrary to his later position when he issued Rev. Rul. 87-72 and withdrew that acquiescence.

Although Petitioner asserts that the Commissioner's position is fifty years old, the whole concept of sourcing was not established until the *General Foods* case in 1947. The language of the Regulations under section 902 on which the Petitioner relies so heavily was not a part of the Regulations until 1965. Furthermore, the Petitioner's quotation (Pet. at p. 10) from Treasury Regulation §1.902-3(c) is not quite complete. The omitted portion goes on to say:

> Since . . . the *accumulated profits*, determined in accordance with subparagraph (1) of this paragraph, for the taxable year *are always equal to the total amount of the gains, profits, and income* for such year, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. Treas. Reg. §1.902-3(c)(4) [Emphasis supplied].

Thus in 1965, only five years before the first dividend involved in the present case, a new Regulation essentially supported the Respondent's position. This language, moreover, still appears in the Regulation. This is hardly fifty years of consistency.

Finally, perhaps it is not unfair to point out that in the present case a similar net operating loss of the very same British subsidiary for 1972 was allowed by the Internal Revenue Service in computing the Respondent's foreign tax credit in this case.

3. The decisions of this Court cited by Petitioner have no relevance whatever to the present controversy.

American Chicle Co. v. United States, 316 U.S. 450 (1942), interpreted the language of section 131 of the Revenue Acts of 1938 and 1939, a predecessor of section 902, with respect to a different question. Section 131 used a formula similar to that in the present case. The dispute, however, was as to T in the formula. The taxpayer argued that the tax in the formula represented the total tax imposed on the subsidiary's total profit (before tax) for the year. The government asserted the tax in the formula should be only the tax attributable to the subsidiary's after-tax profit (that is, total tax multiplied by after-tax profit divided by profit before tax). This Court held for the government, overruling several conflicting decisions.

The effect of this decision was to prevent the domestic parent from ever recovering as a credit the portion of the tax imposed on the profit used to pay the tax. After considerable subsequent debate, section 902 was amended in 1962 to allow the larger credit, contrary to this Court's opinion, but at the same time to require that the dividend to the parent be increased by the "tax deemed paid" (the process known as grossing-up).

The *American Chicle* case did not involve any dispute as to the meaning of "accumulated profits;" the decision in no way controls the present case. It is

interesting to note, however, that the opinion did say, referring to the faults of a still earlier version of the statute:

> Thus, if dividends were paid out of surplus earned in prior years, and it happened that the subsidiary paid no tax to the foreign country in the taxable year in question, the parent could claim no credit whatever. There were other eccentric results flowing from the provision of the Act of 1918. 316 U.S. at 453.

And that, in fact, is the "eccentric result" the Petitioner seeks in the present case.

Biddle v. Commissioner, 302 U.S. 573 (1938), relates to the *direct* tax credit which could be claimed by an individual shareholder of a foreign corporation. It did not involve the credit for taxes *deemed paid* at all, nor did it involve the income of the foreign corporation.

4. **This case was rightly decided by the Court of Appeals.** The Petitioner has derided the decision below as consisting of "little more than perfunctory analysis" departing from "the well-established interpretation" by the Commissioner "in a remarkably casual fashion." Pet. at 9 & 12. This *ad hominem* criticism is quite unjustified. The case for the Petitoner was ably briefed and ably defended in oral argument. The decision of the three judge panel was unanimous and was expressed in an opinion obviously well researched and well thought out. It was considered again on a motion for rehearing, which was denied, and again on a suggestion for rehearing before the entire Court of Appeals, which was declined with one dissent.

And even the trial court, which held for the Petitioner, said:

> *The court does not hold, however, that accumulated profit is in all cases equivalent to United States earnings and profits* and should be computed exactly as if the foreign subsidiary were itself a domestic corporation. Such a conclusion must be arrived at independently on a case by case basis given the complexities inherent in the applicable code provisions and in order to reach the underlying purposes Congress had in mind when enacting the indirect tax credit legislation. Pet. App. at p. 19a [Emphasis supplied].

And the same trial court went on to say:

> The relation of "gains, profits and income" to foreign income taxes indicates this *tax concept is to be equated with foreign taxable income.* "Earnings and profits," on the other hand, appear in this instance to refer to income which would be subject to United States tax. *Cf. Champion Int'l.*, 81 T.C. at 447. Pet. App. at p. 26a [Emphasis supplied].

If it is correct, as the Claims Court said above, that "gains, profits and income" equals foreign taxable income; and if it is correct, as Treasury Regulation §1.902-3(c)(4) says, that "accumulated profits" equals "gains, profits and income," then it must necessarily follow that "accumulated profits" refers to foreign taxable income.

If this conclusion is as clear as it appears to be, how do we account for the result the Claims Court reached? The answer is plain. The Claims Court's decision is based on at least two erroneous assumptions:

> (a) That the Respondent was claiming credit for British tax for the year 1971, which had already been refunded (a "windfall" (Pet. App. at p. 24a), "phantom taxes" (Pet. App. at p. 24a), an "indirect tax credit for taxes its foreign subsidiary did not in fact pay" (Pet. App. at p. 28a)). To the contrary, the claimed credit was for 1968, 1969 and 1970 taxes which had not been refunded.

(b) That the parties agreed that "United States tax law governs the definition of the numerator" in the formula (Pet. App. at p. 20a). They do not so agree, and, because the amount of the dividend allocable to any year is limited to the "accumulated profits" for that year, that is another way of putting the issue in this case.

CONCLUSION

The dispute concerning this esoteric corner of the tax law has been pending since 1975. The Petitioner has had its day in court. Respondent respectfully requests this Court to deny the Petition for a Writ of Certiorari.

April 1989

Respectfully submitted,

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APPENDIX

The Internal Revenue Code of 1954, as in effect for the years 1970 and 1971, provided in pertinent part:

§904 Limitation on Credit

(a) ALTERNATIVE LIMITATIONS.—

(1) PER-COUNTRY LIMITATION.—In the case of any taxpayer who does not elect the limitation provided by paragraph (2), the amount of the credit in respect of the tax paid or accrued to any foreign country or possession of the United States shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(2) OVERALL LIMITATION.—In the case of any taxpayer who elects the limitation provided by this paragraph, the total amount of the credit in respect of taxes paid or accrued to all foreign countries and possessions of the United States shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

§905 Applicable Rules

* * * * *

(c) ADJUSTMENTS ON PAYMENT OF ACCRUED TAXES.—If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected. The amount of tax due on such redetermination, if any, shall be paid by the taxpayer on notice and demand by the Secretary or his delegate, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (sec, 6511 and following). . . .

The Treasury Regulations, as in effect in 1970 and 1971, provided in pertinent part:

§1.902-3 Credit for domestic corporate shareholder of a foreign corporation (after amendment by Revenue Act of 1962).—

* * * * *

(c) Determination of accumulated profits and taxes paid on or with respect thereto.—

* * * * *

(4) Taxes paid on or with respect to accumulated profits of a foreign corporation. For purposes of this section, the amount of foreign income taxes paid or accrued on or with respect to the accumulated profits of a first-tier corporation or second-tier corporation, as the case may be, for any taxable year shall be so much of the foreign income taxes for such year as is properly attributable to such accumulated profits. For such purpose, the foreign income taxes which are properly attributable to the accumulated profits for any taxable year shall be the same proportion of the foreign income taxes imposed on or with respect to the gains, profits, and income for the taxable year as the accumulated profits, as determined under the applicable provision of this paragraph, bear to the total amount of such gains, profits, and income. Since, in applying the preceding sentence to a first-tier corporation which is not a less developed country corporation for the taxable year (and to a second-tier corporation to which subparagraph (3)(i) of this paragraph applies), the accumulated profits, determined in accordance with subparagraph (1) of this paragraph, for the taxable year are always equal to the total amount of the gains, profits, and income for such

year, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. For purposes of this subparagraph, the gains, profits, and income of a foreign corporation for any taxable year shall be determined after reduction by any income, war profits, or excess profits taxes imposed on or with respect to such gains, profits, and income by the United States.

[Petitioner's Calculation of the Foreign Tax Deemed Paid as Stipulated in the Federal Circuit Proceeding]

Exhibit J (Revised)

COMPUTATION OF BRITISH TAX DEEMED PAID USING UNITED STATES TAX CONCEPTS (IN POUNDS STERLING)

	1970	*1971*	*1973*
Profit before Tax and Before 1973 loss (Exs. M thru R)	3,646,611	1,648,254	(3,375,375)
Adjustment to U.S. concepts (Stip. 8)	156,941	1,550,143	4,451,460
Deduction of 1973 loss	-0-	-0-	-0-
Agreed IRS adjustment (Stip. 8)	8,921	26,089	61,067
Profit after losses and before tax (Stip. 7)	3,812,473	3,224,486	1,137,152
Deduction of Irish tax (Stip. 8)		(52,567)	
Deduction of UK tax (Stip. 15 and 19)	(758,437)	-0-	-0-
Adjusted accumulated profit	3,054,036	3,171,919	1,137,152
Dividends received by parent			
Cash	937,600	703,200	879,000
Per agreed IRS adjustment	8,921	26,089	61,067
Total Dividends for year	946,521	729,289	940,067
Allocation of Dividends			
To 1968			
To 1969			
To 1970	946,421		
To 1971		729,289	
To 1973			940,067
	235,038		
		12,086	

$$\frac{\text{Dividends}}{\text{Accumulated Profit After Taxes}} \times \text{Taxes Paid} = \text{Section 902 credit (Sec. 78 income)}$$

1970: $\frac{946{,}521}{3{,}054{,}036} \times 758{,}437 = 235{,}038$ 1971 $\frac{729{,}289}{3{,}171{,}919} \times 52{,}567 = 12{,}086$

[Respondent's Calculation of the Foreign Tax Deemed Paid as Stipulated in the Federal Circuit Proceeding]

Exhibit I (Revised)

COMPUTATION OF BRITISH TAX DEEMED PAID
USING BRITISH TAX CONCEPTS (IN POUNDS STERLING)

	1968	*1969*	*1970*	*1971*	*1973*
Profit before tax and before carry-back of 1973 loss (Ex. M thru R)	3,947,459	1,932,178	3,646,611	1,648,254	(3,375,375)
Adjustment to U.S. concepts	-0-	-0-	-0-	-0-	-0-
Deduction of 1973 loss carry-back (Stip. 8)	-0-	-0-	(1,779,688)	(1,595,687)	-0-
Deduction of Irish tax (Stip. 8)	-0-	-0-	-0-	(52,567)	
Profit after all losses before tax (Stip. 6)	3,947,459	1,932,178	1,866,923	-0-	
Agreed IRS adjustment (Stip. 8)			8,921	26,089	61,067
UK tax (net) (Stip. 15)	(1,752,096)	(833,251)	(758,437)	-0-	-0-
Adjusted accumulated profit	2,195,363	1,098,927	1,117,407	26,089	61,067
Dividends received by parent					
Cash	937,600	937,600	937,600	703,200	879,000
Per agreed IRS adjustment	-0-	-0-	8,921	26,089	61,067
Total Dividends for year	937,600	937,600	946,521	729,289	940,067
Allocation of Dividends					
To 1968	937,600			370,987	879,000
To 1969		937,600		161,327	-0-
To 1970			946,521	170,886	-0-
To 1971				26,089	-0-
To 1973					61,067
Dividends x Tax Divided by Profit (for 1970 and 1971)					
1970: Paid out of 1970: 946,521 x 758,437 Divided by 1,117,407=			642,449		
1971: Paid out of 1968: 370,987 x 1,752,096 Divided by 2,195,363=				296,081	
Paid out of 1969: 161,327 x 833,251 Divided by 1,098,927=				122,325	
Paid out of 1970: 170,886 x 758,437 Divided by 1,117,407=				115,988	
Paid out of 1971: 26,089 x 52,567 Divided by 26,089=				52,567	
Tax deemed paid			642,449	586,961	

No. 88-1474 (3)

In the Supreme Court of the United States

OCTOBER TERM, 1988

UNITED STATES OF AMERICA, PETITIONER

v.

THE GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

WILLIAM C. BRYSON
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TABLE OF AUTHORITIES

In the Supreme Court of the United States

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

This case concerns the construction of a provision of the Internal Revenue Code applicable to the determination of the United States income tax of United States corporations. The question presented concerns the determination under Section 902 of the Code of the "deemed paid" foreign tax credit, which is available to a domestic corporation that receives dividends from a foreign subsidiary that has paid foreign income tax. Specifically, the issue in this case is the meaning of the term "accumulated profits" in Section 902. Departing from the settled rule, the court of appeals held that this term in the Internal Revenue Code refers to profits as computed under foreign law principles; we maintain that it refers to profits as computed under principles of United States law.

We argued in our petition that the court of appeals' interpretation is clearly at odds with congressional intent for

a multitude of reasons. Respondent does not dispute several of the points made in the petition: (1) that the proration of the credit should reflect the ratio that dividends actually paid bears to potential dividends, and therefore that it is inconsistent to compute the "dividends" included in United States income according to United States law (as is undisputed) while computing the "accumulated profits," out of which the dividends are paid, under foreign law (Pet. 13-16); (2) that the court of appeals' interpretation seriously disrupts the proper functioning of the credit and leads to irrational results (Pet. 16); (3) that the decision below undermines the statutory goal of avoiding discrimination between companies that operate through a foreign branch and those that operate through a foreign subsidiary (Pet. 19-22); and (4) that the court of appeals' "plain meaning" approach is faulty because the statute itself states that dividends are paid out of "accumulated profits" (Pet. 13-14). Moreover, respondents' objections to the other points made in our petition are without merit.

1. We noted in our petition (at 5 n.4) that the court of appeals' decision leads to favorable tax consequences for respondent in two different respects: the Section 902 formula allows it a credit for a greater percentage of the foreign taxes paid in 1970; and, under the annualization approach of Section 902 (see Pet. 4 n.3), the reduction in 1971 "accumulated profits" allows respondent to treat the 1971 dividend as having been paid in part out of profits earned in earlier years, thus allowing it to take a Section 902 credit on its 1971 federal income tax return for foreign taxes paid in the years 1968 and 1969 as well. Respondent asserts that this latter feature of the case, which it terms "sourcing" the dividend, is critical to its resolution. See Br. in Opp. 3-7. In fact, the concept of "sourcing" is quite collateral to the threshold question presented here—whether the profits to which the dividends are sourced are computed under foreign law or under the law of the United States. Only after that question is answered can the sourcing calculation be made.

Respondent argues (Br. in Opp. 5-7) that domestic concepts of taxable income and of earnings and profits cannot be relevant to the process of "sourcing," and therefore cannot be used to detemine "accumulated profits," because the profits in question are those of a foreign corporation that is not directly subject to United States taxation. Respondent's argument appears to rest on the idea that, because its subsidiary is subject to foreign tax, the dividends it received from the subsidiary should be deemed to have been paid out of the latter's profits as computed by British law. This analysis is fundamentally misconceived. This case involves the federal income taxation of United States corporations. The Section 902 credit grants relief from federal taxation with respect to the dividends that a domestic company receives from a foreign subsidiary and reports as income on its United States return. Just as United States law determines how much of the distribution constitutes a "dividend"—by looking to whether the money was paid out of "earnings and profits"—so it must also determine the "accumulated profits" out of which the dividend is paid.[1]

Respondents' objection to the government's interpretation on the ground that it permits dividends to be at-

[1] Indeed, respondent recognizes that "accumulated profits" must be correlated with the source of the dividends. Respondent notes that "[t]he determination of [dividends] for each year depends on the 'accumulated profits' for the year, since the dividend is allocated according to the profits available for paying it" (Br. in Opp. 5). The "profits available for paying" a dividend received by a United States taxpayer are defined by Section 316 of the Code as "earnings and profits," which are computed under United States law. See I.R.C. § 312.

tributed to the accumulated profits of a year in which "there appears to be profit but no foreign tax" (Br. in Opp. 5) is unfounded. This result is no "distortion of the credit" (*id.* at 7); rather, it is the necessary and appropriate consequence of the favorable tax treatment allowed to respondent's subsidiary by British law. As we explained in the petition (at 19), because British law permitted a loss and carryback to 1970 and 1971 not available under United States law, the subsidiary's profits for those years when computed under United States law were much higher than under British law, *and the subsidiary paid no tax to Britain on those additional United States profits.* Those profits computed under United States law were sufficient to cover the dividends that the subsidiary distributed in 1970 and 1971, and the Commissioner accordingly "sourced" those dividends to those profits for purposes of computing the Section 902 credit. See Pet. App. 23a-24a. Since the subsidiary paid no foreign tax on the additional "United States profits," there was no danger that those profits would be subjected to double taxation when distributed as dividends includable in respondent's United States income. Under the statutory scheme, respondent simply is not entitled to any foreign tax credit with respect to those profits—a manifestly reasonable result since it paid no foreign tax on them. By contrast, respondent's position distorts the credit and seeks a substantial windfall by treating the dividends in question as a distribution of profits earned in prior years when the subsidiary paid higher taxes to Britain—profits that have not yet been distributed to respondent under the governing rules of Sections 312 and 316 of the Code.

2. a. Respondent disputes (Br. in Opp. 11-13) our contention (see Pet. 9-12) that the decision below overturns a rule that was recognized by the Tax Court and well

settled by more than 50 years of uniform administrative practice and a Treasury Regulation directly in point. Instead, respondent suggests that the Commissioner did not definitively declare that United States principles govern the determination of "accumulated profits" until prompted to do so by this litigation, arguing that previous rulings and regulations addressed to the subject were ambiguous at best. Respondent's contentions are without merit.

As stated in the petition (at 9-10), the Commissioner issued a ruling in 1933 to the effect that special deductions and similar items allowed by a foreign country as offsets to taxable income, but not allowed as deductions under United States tax laws, do not reduce accumulated profits for purposes of the Section 902 credit. The ruling explained that accumulated profits include "all income of the foreign corporation available for distribution to its shareholders, whether such profits be taxable by the foreign country or not." I.T. 2676, XII-1 C.B. 48, 50 (1933). The inventory adjustments and accelerated depreciation that respondent's subsidiary claimed under British law are examples of "special deductions," which the ruling specifies do not serve to decrease accumulated profits. The position taken by the Treasury in this case is therefore no different from the one it announced in 1933.

Since the publication of the 1933 ruling, the Treasury has consistently followed the principle that "accumulated profits" are determined by United States law. In 1963, it promulgated a Revenue Ruling that quoted the 1933 ruling with approval and concluded that the calculation of accumulated profits is based on the concept of earnings and profits in Section 316 of the Code. Rev. Rul. 63-6, 1963-1 C.B. 126. Even respondent recognizes that this Revenue Ruling squarely holds that "U.S. rules should govern the determination of 'accumulated profits' " (Br. in Opp. 11),

and the Commissioner has never departed from this ruling.[2]

Respondent's assertion (Br. in Opp. 12) that the applicable Treasury regulation, Treas. Reg. § 1.902-3(c)(1) (1965), departs from Rev. Rul. 63-6 and "essentially support[s]" respondent's position is misconceived. As we stated in the petition (at 10), the definition of "accumulated profits" of a foreign subsidiary in this long-standing regulation unequivocally correlates them with its "earnings and profits." Respondent adverts to a different paragraph of the regulation, Treas. Reg. § 1.902-3(c)(4) (1965), that does not define the term "accumulated profits," but rather construes the statutory phrase "taxes paid * * * on or with respect to such accumulated profits." As explained in the petition (at 16-18 & n.7), this is the

[2] Respondent's assertion (Br. in Opp. 11) that the Treasury reversed itself by later declaring this ruling "obsolete" (see Rev. Rul. 72-261, 1972-2 C.B. 651) is plainly unfounded. The ruling was never revoked; it is common for a ruling to be classified as "obsolete" (*i.e.*, not controlling for future transactions) when the ruling has become "unnecessary because the issue has been covered by regulations" (Rev. Proc. 67-6, 1967-1 C.B. 576, 577). That is precisely what occurred here. The ruling construed Section 902 as it read before amendment by the Revenue Act of 1962. Subsequent to that statutory change, the Treasury promulgated a formal regulation, Treas. Reg. § 1.902-3(c)(1) (1965), interpreting the amended statute. Because that regulation embodied the substance of Rev. Rul. 63-6 and construed the new version of the statute, the ruling was properly declared "obsolete" under the criteria developed by the Treasury for reducing the number of outstanding rulings. Rev. Rul. 63-6 and the regulation, now codified in its present form as Treas. Reg. § 1.902-1(e), continue to be recognized as embodying Treasury's position that "accumulated profits" are computed in accordance with the principles governing the calculation of earnings and profits under United States law. See S. Rep. No. 313, 99th Cong., 2d Sess. 299 n.6 (1986); *Champion International Corp.* v. *Commissioner*, 81 T.C. 424, 433 (1983).

statutory phrase that gave rise to the so-called *American Chicle* limitation. The purpose of this paragraph of the regulation is to reflect the change made by the Revenue Act of 1962 and make clear that the foreign tax "paid * * * with respect to such accumulated profits" equals the entire foreign tax without reduction on account of the *American Chicle* limitation. See Pet. 17 n.7. Nothing in this paragraph undermines the explicit definition in subparagraph (1) of "accumulated profits" in terms of "earnings and profits" computed under United States law; indeed, the paragraph quoted by respondent specifically incorporates that definition.[3]

b. Respondent's assertion (Br. in Opp. 8, 11-12) that *Champion International Corp.* v. *Commissioner*, 81 T.C. 424 (1983), in which the Commissioner acquiesced, decided the issue presented in this case in respondent's favor is without foundation. *Champion* involved a different issue. The foreign subsidiary in that case, unlike respondent's subsidiary, sustained a loss that could be carried back under both United States tax law and the tax law of Canada. The question in the case was the year in which the loss should be recognized for purposes of computing "accumulated profits." The Tax Court's holding permitting the carryback sought by the taxpayer thus was fully con-

[3] Seizing on a misstatement by the Claims Court (Pet. App. 26a), respondent asserts (Br. in Opp. 7, 12, 15) that the term "gains, profits, and income" necessarily refers to profits computed under foreign tax principles and therefore contends that subparagraph (4) of the regulation directly supports its position. This contention is clearly mistaken. The phrase relied upon by respondent is taken directly from the statutory definition of "accumulated profits" (I.R.C. § 902(c)(1)). If that phrase had a recognized meaning as income determined under foreign law principles, it would be unnecessary to look beyond Section 902(c)(1) to resolve this case. In fact, the meaning of that phrase is the question presented here, not the answer.

sistent with the government's position here. Indeed, the court so stated, noting that "[t]he accumulated profits in the denominator [of the Section 902 fraction] represent the fund from which the dividends were paid and must be determined in accordance with U.S. law" (81 T.C. at 433; see also *id.* at 431).[4] As noted in our petition (at 11), the court went on to distinguish and reaffirm its earlier decision in *Steel Improvement & Forge Co.* v. *Commissioner,* 36 T.C. 265, 276-282 (1961), rev'd on other grounds, 314 F.2d 96 (6th Cir. 1963), which held that "accumulated profits" must be determined under United States law (see 81 T.C. at 446-447). In *Steel Improvement,* as here, the loss claimed by the foreign subsidiary was allowed only by foreign law, and the Tax Court accordingly held that it could not be used to offset the subsidiary's accumulated profits. Respondent does not dispute our characterization of *Steel Improvement* as directly in point.

Thus, in the words of a commentator on the decision below, the Federal Circuit has "adopted an approach to the § 902 deemed paid credit fraction which is different from the generally accepted view that (E & P) and accumulated profits are computed in accordance with U.S. concepts * * *." Fuller, *Section 902 Accumulated Profits: The Federal Circuit Takes a Different View in* Goodyear, 17 Tax Mgmt. Int'l J. (BNA) 502, 503 (1988). That generally accepted view is reflected in the Tax Court's decisions, the published position of the Treasury, and numerous commentators on the foreign tax credit.[5] The decision below departing from that view is unfounded and threatens serious disruption of the fair administration of the foreign tax credit provisions.

3. Respondent asserts that the issue in this case is not sufficiently important to merit review by this Court (Br. in Opp. 8-9), but it does not refute our submission (Pet. 22-26) that the decision below is of enormous importance to the public fisc and places the IRS in a whipsaw posture with respect to the Section 902 credit claims of multinational corporations. Moreover, as we explained in our petition (at 24-26), the issue in this case retains continuing significance even after the enactment of the 1986 Tax Reform Act because the pre-1986 method for computing the foreign tax credit has been retained indefinitely for dividends paid from pre-1987 profits—a fact that has been duly noted by tax practitioners. See Fuller, *supra*, 17 Tax Mgmt. Int'l J. (BNA) at 503 (decision below "could have a major impact on foreign tax credit planning"); Burda, *The Foreign Loss Carryback Dilemma: Gone But Not Forgotten*, 13 Int'l Tax J. 199, 224 (1987) (treatment of foreign losses "is still a problem" after 1986 Act and "will not be eliminated until all pre-1987 accumulated profits are finally repatriated as dividends to the U.S. shareholders"). In short, the decision below raises a substantial and continuing impediment to the proper administration of the foreign tax credit.

---

[4] Similarly, respondent errs in suggesting (Br. in Opp. 13) that the Commissioner acted inconsistently in allowing respondent to consider a loss sustained by its British subsidiary in 1972 in computing its foreign tax credit. The loss incurred in 1972 was not "similar" to the one involved here; it was a loss recognized under both United States and British tax law (see Pet. App. 10a). Thus, the 1972 loss was akin to the loss in *Champion* and dissimilar in a critical respect from the 1973 loss involved here.

[5] See, *e.g.*, Pet. 11 n.5; *Federal Income Tax Project: International Aspects of United States Income Taxation* 398 (A.L.I. 1987); Mentz, *The Effect of Net Operating Losses on the Foreign Tax Credit,* 30 Tax Law. 309, 324 n.36, 333 (1977); Burda, *The Foreign Loss Carryback Dilemma: Gone But Not Forgotten*, 13 Int'l Tax J. 199, 206 (1987).

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General

APRIL 1989

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(8)

No. 88-1474

In the Supreme Court of the United States

OCTOBER TERM, 1988

UNITED STATES OF AMERICA, PETITIONER

v.

THE GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

JOINT APPENDIX

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PETITION FOR WRIT OF CERTIORARI
Filed March 8, 1989
CERTIORARI GRANTED MAY 1, 1989

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* The opinion and judgment of the court of appeals, the order of the court of appeals denying rehearing, and the opinion of the Claims Court, are printed in the appendix to the petition for writ of certiorari and have not been reproduced here.

UNITED STATES CLAIMS COURT

No. 510-85-T

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES

v.

THE UNITED STATES

DOCKET ENTRIES

DATE	PROCEEDINGS
Sep. 6, 1985	Filing fee of $60 paid by plaintiff.
Sep. 6, 1985	Notice of assignment to Judge Moody R. Tidwell filed. Copy to parties.
Sep. 9, 1985	Judge's order governing proceedings before trial filed. Copy to parties. [Counsel to file jointly OGPAT: 14 days before trial; memorandum of fact and law to be filed: 7 days before trial and cannot exceed 10 pages.]
Oct. 30, 1985	Defendant's motion for extension of time (to December 15, 1985) to file its answer filed. Service by mail: 10/30/85. ALLOWED: NOV. 12, 1985.
Dec. 16, 1985	Defendant's answer filed. Service by mail: 12/16/85.
Dec. 17, 1985	Judge's order re Appendix G filed. Copy to parties.

Jan. 16, 1986	Joint preliminary status report filed.
Mar. 7, 1986	Defendant's motion for enlargement of time (to June 30, 1986) for discovery filed. Service by mail: 3/7/86. ALLOWED: MAR. 11, 1986.
Jun. 11, 1986	Defendant's motion for enlargement of time (to August 4, 1986) to file stipulation of facts with appended exhibits and request to modify briefing schedule proposed in joint preliminary status report (Pltf's motion for summary judgment: 45 days after filing of stipulation of facts; defendant's cross-motion: 45 days after service; plaintiff's reply: 30 days after service; defendant's reply: 30 days after service) filed. Service by mail: 6/11/86. ALLOWED: JUN. 13, 1986.
Aug. 1, 1986	Defendant's motion for enlargement of time (to September 18, 1986) for parties to file stipulation of facts with appended exhibits and request to modify briefing schedule filed. Service by mail: 8/1/86. [Pltf's motion for summary judgment: 45 days after filing of stipulation; defendant's cross-motion: 45 days after service of pltf's motion; plaintiff's reply: 30 days after service of deft's cross-motion; deft's reply: 30 days after service of plft's reply] ALLOWED: SEP. 4, 1986.
Sep. 16, 1986	Joint motion for enlargement of time (to October 27, 1986) to file its stipulation of facts, etc. filed by deft. Service

	by mail: 9/15/86. ALLOWED: SEP. 18, 1986.
Oct. 24, 1986	Joint motion for enlargement of time (to December 8, 1986) to file a stipulation of facts, etc., and to modify briefing schedule re: motions for summary judgment (pltfs.' brief: 45 days from filing of stipulation of facts—45 days from service—30 days from service—30 days from service) filed by deft. Service by mail: 10/24/86. ALLOWED: OCT. 28, 1986.
Dec. 4, 1986	Joint motion for enlargement of time (to January 12, 1987) to file stipulation of facts and to retain the briefing schedule as to motions for summary judgment filed. ALLOWED: 12/16/86.
Jan. 12, 1987	Joint motion for enlargement of time (to March 2, 1987) to file stipulation of facts with joint appended exhibits filed. ALLOWED: 1/14/87 but no more enlargements of time will be allowed.
Jan. 15, 1987	Defendant's motion to reopen discovery for a period not exceeding 90 days following the filing of plaintiff's motion for summary judgment filed. Service: 1/15/87. DENIED: FEB. 6, 1987.
Feb. 27, 1987	Joint motion to modify briefing schedule: 1. Plaintiff's motion for summary judgment 45 days after filing of stipulation of facts; 2. cross-motion 45 days from service;

	3. reply brief 30 days from service and; 4. reply brief 30 days from service, filed. ALLOWED: 3/3/87.
Mar. 2, 1987	Stipulation of facts filed.
Apr. 15, 1987	Plaintiff's motion for summary judgment together with an appendix in (1 volume) filed. Service: 4/15/87.
Apr. 15, 1987	Plaintiff's proposed findings of additional uncontroverted fact filed. Service: 4/15/87.
Apr. 17, 1987	Joint motion to substitute exhibits to stipulation of facts filed. [Exhibits attached to motion.] ALLOWED: APR. 20, 1987.
May 8, 1987	Defendant's motion for enlargement of time (to June 24, 1987) to file its cross-motion for summary judgment filed. Service: 5/8/87. ALLOWED: MAY 11, 1987.
Jun. 12, 1987	Defendant's motion for leave to exceed page limit (by 10 pages) filed. Service: 6/12/87. ALLOWED: JUN. 15, 1987.
Jun. 29, 1987	Defendant's cross-motion for summary judgment, together with a separate volume of appendix filed [by leave of the judge]. Service: 6/24/87.
Jul. 9, 1987	Plaintiff's motion for substitution of attorney of record [from Stephen L. Buescher (who consents) to Barring Coughlin] filed. Service: 7/8/87.
Jul. 27, 1987	Plaintiff's reply brief, together with a separate volume of appendix, filed. Service: 7/27/87.

Aug. 12, 1987	Defendant's motion for enlargement of time (to September 25, 1987) to file its reply brief filed. Service: 8/12/87. ALLOWED: AUG. 17, 1987.
Sep. 25, 1987	Defendant's reply brief filed. Service: 9/25/87.
Dec. 8, 1987	Judge's order filed. Copy to parties.
Dec. 9, 1987	Judgment entered dismissing complaint. Costs to prevailing party. Copy to parties.
Jan. 25, 1988	Plaintiff's notice of appeal filed. Copy to defendant and C.A.F.C. [$105 fee paid]. C.A.F.C. No. 88-1201.

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 88-1201

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, APPELLANT

v.

THE UNITED STATES, APPELLEE

DOCKET ENTRIES

DATE	PROCEEDINGS AND ORDERS
January 25, 1988	Notice of appeal filed in the Claims Court. (lc)
January 26, 1988	Notice of appeal and certified list, received. (lc) COUNSEL FOR THE APPELLANT: Barring Coughlin COUNSEL FOR THE APPELLEE: Gary R. Allen
February 16, 1988	Certificate of Interest for the Appellant, filed. Certificate of Interest for the Appellee, filed.
January 27, 1988	Notice of appeal and certified list, filed. Appeal docketed and notice sent to parties. (lc)

March 24, 1988	BRIEF & SEPARATE ADDENDUM FOR APPELLANT, filed. (SD-3/24-H) (jb)
April 25, 1988	1. Appellee's motion to extend time for filing brief (to & including May 13, 1988), filed. (SD-4/22-M). (bam) (EOD 4/26/88) GRANTED: 4/27/88. (per fxg on 4/26/88). (bam)
May 13, 1988	2. Appellee's motion for an extension of time, to & including May 27, 1988, to file its brief, filed. (SD-5/12-M) scg GRANTED: 5/16/88. (per fxg). (bam)
May 27, 1988	BRIEF FOR THE APPELLEE, filed. (SD-5/27-M) (jb)
June 3, 1988	3. Appellants' motion to extend time to file reply brief (to & including June 23, 1988), filed. (SD-6/3-H). (bam) (EOD 6/6/88) GRANTED: 6/6/88. (per fxg). (bam) (W/LTR)
June 8, 1988	JOINT APPENDIX, filed. (SD-6/8-M) (jb)
June 8, 1988	4. Letter to counsel Coughlin & Allen re ORAL ARGUMENT JULY 7/G. df
June 22, 1988	REPLY BRIEF FOR THE APPELLANT, filed. (SD-6/22-M) (cr)
July 6, 1988	5. Appellant's citation of additional authority, received, pjt (Circulated to panel)
July 7, 1988	ARGUED. (Newman & Bissell, JJ, & Re, J) df

July 11, 1988	6. Appellee's response to questions raised at oral argument, rec'd. (SD-7/8-M). (bam) (EOD 7/12/88) (Circulated to panel on 7/12/88). (bam)
July 18, 1988	7. Appellant's letter regarding letter of appellee responding to questions raised at oral argument, rec'd. (SD-7/15-M). (bam) (EOD 7/19/88) (Circulated to panel on 7/19/88). (bam)
August 31, 1988	REVERSED. (Bissell, J) "JUDGMENT ENTERED" (lc) (F. 2d. 856-0170)
Sept. 8, 1988	8. Appellee's motion to extend time for filing petition for rehearing (to & including Oct. 14, 1988), filed. (SD-9/7-M). (bam) (EOD 9/9/88) GRANTED: 9/12/88. (per bam). (bam)
Sept. 13, 1988	9. Bill of costs against appellee, filed. (SD-9/12-M). (bam) (EOD 9/14/88) (ALLOWED: Nov. 15, 1988, for $1192.00. (scg)
Sept. 20, 1988	10. Letter from appellee objection to $948.00 of appellant's proposed bill of costs, filed. (scg)
October 14, 1988	APPELLEE'S PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC, filed. (SD-10/14-M) (jb) 10/25/88: SOP 16 circulated. (df) DENIED: 11-08-88. (ld) 11/10/88: SOP 18 circulated. (ld) 11-18-88 letter to appellant requesting response to suggestion for rehearing in banc by 12-5-88. (ld) DECLINED: 12/28/88. Judge Archer would rehear the case. (df)

Nov. 15, 1988	MANDATE ISSUED TO U.S. CLAIMS COURT. (scg)
Nov. 22, 1988	11. Appellant's motion to extend time for filing response to sugg for rehearing en banc, filed. (SD-11/22-M) (GRANTED: Nov. 23, 1988; per fxg; TO AND INCL DEC. 19, 1988) scg
December 9, 1988	APPELLANT'S RESPONSE TO APPELLEE'S SUGGESTION FOR REHEARING IN BANC, filed (SD-12/9-H). (ld) SOP 18 circ. 12-15-88 (ld)
February 3, 1989	12. Letter from S. Ct. advising that application for an extension of time to file a petition for a writ of certiorari was granted by CJ on 01-25-89 extending time to and including 03-08-89. (ld)
March 8, 1989	PETITION FOR WRIT OF CERTIORARI, filed (S. CT. NO. 88-1474). (ld) GRANTED: 05-01-89. (ld)

IN THE UNITED STATES CLAIMS COURT

No. 510-85 T

THE GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES, PLAINTIFF

v.

THE UNITED STATES OF AMERICA, DEFENDANT

COMPLAINT

[Filed Sept. 6, 1985]

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1. Plaintiff, The Goodyear Tire & Rubber Company and Affiliates, is an affiliated group of domestic corporations which filed a consolidated Federal income tax return for each of the years here involved. The Goodyear Tire & Rubber Company ("Goodyear"), is a corporation organized and existing under the laws of the State of Ohio, with its principal office located at 1144 East Market Street, Akron, Ohio 44316. Its Employer Identification Number is 34-0253240. Defendant is the United States of America.

2. This action is a claim for refund of Federal income taxes for the years 1970 and 1971 arising under the Internal Revenue Code of 1954, as amended, and the jurisdic-

tion of this Court is invoked under the provisions of Title 28, United States Code, Section 1491.

3. Plaintiff files its consolidated Federal income tax returns on the calendar year basis and employs the accrual method of accounting in keeping its books and records and in filing its consolidated Federal income tax returns.

4. On or about September 14, 1971, and September 15, 1972, Plaintiff filed consolidated Federal income tax returns for the years ending December 31, 1970, and December 31, 1971, respectively, with the Internal Revenue Service Center at Cincinnati, Ohio. The address and Employer Identification Number on the returns were as set forth in Paragraph 1. On those dates or earlier, and at later dates in accordance with the agreed adjustments described in Paragraph 8, Plaintiff paid income tax amounting to $46,263,462 and $78,013,209 for the years ending December 31, 1970, and December 31, 1971, respectively.

5. In its returns, Plaintiff claimed foreign tax credits under Section 902 for taxes deemed paid to Great Britain in the amounts of $1,255,871 and $807,124 for the years ending December 31, 1970, and December 31, 1971, respectively.

6. The Goodyear Tire & Rubber Company (Great Britain) Limited ("Goodyear England"), a wholly-owned subsidiary of Goodyear incorporated in Great Britain and not a member of the affiliated group constituting the Plaintiff herein, reported the following taxable income in the years indicated for purposes of British taxes (in pounds):

1970	£ 3,646,611
1971	3,357,844
1972	(1,397,828)
1973	(3,457,724)

7. In its returns for 1970 and 1971 the Plaintiff reported that Goodyear England had paid the following dividends to Goodyear (in pounds):

1970	£ 937,600
1971	703,200

8. Pursuant to an agreed adjustment between Plaintiff and the Commissioner of Internal Revenue finalized on June 30, 1978, the following items relating to the computation of the credit computed under Section 902 of the Internal Revenue Code for taxes deemed paid by Goodyear with respect to the dividends referred to in Paragraph 7, were agreed to for 1970 and 1971 (in pounds except where otherwise indicated):

	Accumulated Profits	Dividend	British Tax Paid	US deemed paid tax credit relating to Goodyear England
1970	£2,382,437	£946,521	£1,430,036	$1,356,562
1971	2,521,919	729,289	702,567	493,901

9. In 1975 Goodyear England submitted a Corporation Tax Computation for the calendar year 1973 to the Inland Revenue in Great Britain. This computation claimed the benefit of deductions allowed under the Finance Act of 1975, Section 18, and the Finance Act of 1971, Section 42, as amended by the Finance Act of 1972, Section 67(a), and the Finance Act of 1971, Section 177(3A) of the statutes of Great Britain, in the aggregate amount of £4,533,809, resulting in a loss for 1973 of £3,457,724.

10. In accordance with the Finance Act of 1971, Section 177(3A) of the statutes of Great Britain, the loss of £3,457,724 for 1973 was applied first to 1972. Since 1972 was itself a loss year, the 1973 loss was then applied to offset 1971 income and part of 1970 income.

11. As a result of the net loss for 1973 and pursuant to the statutes of Great Britain referred to in Paragraph 9, the British government made payments to Goodyear England in 1975 and 1976 equal to £671,599 of the £1,430,036 in taxes paid by Goodyear England for 1970 and £650,000 of the £702,567 in taxes paid by Goodyear England for 1971.

12. Under date of November 21, 1980, the Commissioner of Internal Revenue assessed a deficiency for the year ending December 31, 1970, in the amount of $323,654 plus interest thereon in the amount of $132,611.66, and under date of November 21, 1980, the Commissioner of Internal Revenue assessed a deficiency for the year ending December 31, 1971, in the amount of $237,616 plus interest thereon in the amount of $97,359.06.

13. The assessed deficiencies and interest resulted from the determination by the Commissioner of Internal Revenue that the foreign tax credits claimed by Plaintiff with respect to dividends received by Goodyear from Goodyear England for the years ending December 31, 1970, and December 31, 1971, should be reduced based upon an adjustment under Section 905 of the Internal Revenue Code.

14. Further, in computing the amount of the reduced credits, the Commissioner of Internal Revenue determined that taxes paid by Goodyear England should be reduced, but failed to further adjust Goodyear England's 1970 and 1971 accumulated profits.

15. The actions taken by the Commissioner of Internal Revenue described in the two preceding paragraphs were erroneous.

16. In response to the assessments described in Paragraph 12, on or about December 1, 1980, Plaintiff paid to the Internal Revenue Service Center, Cincinnati, Ohio, the following amounts for the years indicated:

Year	Tax	Interest
1970	$323,654.00	$132,611.66
1971	237,616.00	97,359.06

17. The aggregate amount thereby paid by Plaintiff with respect to its income tax liability for the year ending December 31, 1970, was $46,587,116 and for the year ending December 31, 1971 was $78,250,825.

18. Plaintiff's correct income tax liability for the years ending December 31, 1970, and December 31, 1971, was $46,263,462 and $78,013,209, respectively.

19. Plaintiff has thereby overpaid its income tax for the years ending December 31, 1970, and December 31, 1971, by the amounts set forth in Paragraph 16.

20. On or about November 29, 1982, Plaintiff filed with the Internal Revenue Service Center, Cincinnati, Ohio, a timely claim for refund of $323,645.00 of assessed tax and $132,611.66 of assessed interest for the year ending December 31, 1970, and $237,616.00 of assessed tax and $97,359.06 of assessed interest for the year ending December 31, 1971, together with interest on those amounts as required by law, on the ground that Goodyear is entitled to additional foreign tax credits for taxes deemed paid with respect to the dividends referred to in Paragraph 7 in the amounts of $637,097 and $456,953 for the years ending December 31, 1970, and December 31, 1971, respectively. The address and Employer Identification Number on the claims were as set forth in Paragraph 1.

21. Under date of September 30, 1983, the Regional Commissioner of Internal Revenue by certified mail issued its notice of disallowance of said claim for refund.

22. No action on this claim has been taken by the Congress of the United States or by any Department of Government, except as hereinbefore set forth.

WHEREFORE, Plaintiff Goodyear Tire & Rubber Company and Affiliates prays for Judgment against defendant in the amount of $791,240.72 together with interest as provided by law, and for such other and further relief as this Court may deem proper.

Respectfully submitted,

/s/ Barring Coughlin
BARRING COUGHLIN

/s/ Stephen L. Buescher
STEPHEN L. BUESCHER—Of Record
Attorneys for Plaintiff
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September 4, 1985

IN THE UNITED STATES CLAIMS COURT

No. 510-85 T

THE GOODYEAR TIRE & RUBBER COMPANY
AND AFFILIATES, PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

ANSWER

[Filed Dec. 16, 1985]

Defendant, the United States, by its attorneys, in response to plaintiff's complaint filed September 6, 1985, denies each and every allegation contained therein, not admitted, qualified, or otherwise referred to below.

Defendant further:

1-3. Admits the allegations contained in paragraphs 1-3.

4. Admits the allegations contained in paragraph 4, except avers that its attorneys presently are unable to obtain knowledge or information sufficient for them to form a belief as to the truth of the allegations relating to the "agreed adjustments described in Paragraph 8".

5. Admits the allegations contained in paragraph 5.

6. Avers that its attorneys are unable to obtain knowledge or information sufficient for them to form a belief as to the truth of the allegations contained in paragraph 6.

7. Admits the allegations contained in paragraph 7, except avers that plaintiff in its returns for 1970 and 1971 reported that Goodyear England paid dividends to it of $2,238,727.04 for 1970 and $1,709,244.80 for 1971 rather than in United Kingdom currency of 937,600 pounds and 703,200 pounds, respectively. Avers that when the above amounts in United Kingdom currency are multiplied by the respective exchange rates of 2.387720819 for 1970 and 2.4306666666 for 1971 as set forth in plaintiff's income tax returns, the resulting products equal the above respective dollar amounts in United States currency.

8. Avers that its attorneys presently are unable to obtain knowledge or information sufficient for them to form a belief as to the truth of the allegations contained in paragraph 8.

9-11. Avers that its attorneys are unable to obtain knowledge or information sufficient for them to form a belief as to the truth of the allegations contained in paragraphs 9-11.

12-14. Admits the allegations contained in paragraphs 12-14.

15. Denies the allegations contained in paragraph 15.

16. Admits the allegations contained in paragraph 16, except avers that plaintiff paid the income tax deficiencies and assessed interest for the tax years 1970 and 1971 on December 3, 1980.

17. Admits the allegations contained in paragraph 17.

18-19. Denies the allegations contained in paragraphs 18-19.

20. Admits the allegations contained in paragraph 20, except denies each and every allegation contained in plaintiff's claims for refund for the tax years 1970 and 1971, unless specifically admitted herein.

21. Admits the allegations contained in paragraph 21.

22. Avers that its attorneys are unable to obtain knowledge or information sufficient for them to form a belief as to the truth of the allegations contained in paragraph 22.

WHEREFORE, defendant prays that plaintiff's complaint be dismissed with prejudice at plaintiff's own costs.

Respectfully submitted,

/s/ Glenn L. Archer, Jr.
GLENN L. ARCHER, JR.
Assistant Attorney General

/s/ Robert N. Dorosin
ROBERT N. DOROSIN
Attorney
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December 13, 1985

IN THE UNITED STATES CLAIMS COURT

No. 510-85 T

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

STIPULATION OF FACTS

[Filed Mar. 2, 1987]

Plaintiff and defendant hereby stipulate that the facts contained herein are true and accurate for purposes of the above-entitled case only. Each of the parties reserves the right to contest the relevance of any fact stated herein, and to present such other evidence as may be appropriate.

1. Plaintiff, The Goodyear Tire & Rubber Company and Affiliates, is an affiliated group of domestic corporations which filed a consolidated Federal income tax return for each of the years here involved. The Goodyear Tire & Rubber Company ("Goodyear") is a corporation organized and existing under the laws of the State of Ohio, with its principal office located at 1144 East Market Street, Akron, Ohio 44316, and the parent of the affiliated group constituting the plaintiff. Its Employer Identification Number is 34-0253240. Defendant is the United States of America.

2. This is a suit for refund of Federal income taxes for the years 1970 and 1971 arising under the Internal Revenue Code of 1954, as amended. Jurisdiction of the Claims Court is invoked under Title 28, United States Code, Section 1491.

3. During the years involved, and for all preceding and following years, plaintiff filed its consolidated Federal income tax returns on the calendar year basis and employed the accrual method of accounting in keeping its books and records and in filing its consolidated Federal income tax returns. Plaintiff did not make the election with respect to its wholly owned United Kingdom subsidiary, Goodyear Tyre & Rubber Company Ltd., under Treasury Regulation Section 1.902-3(c)(5) (1971) or any other applicable Treasury Regulation to be governed by Section 964 and did not make the election under Section 963(a) to exclude Subpart F income. A copy of Section 1.902-3(c) (1971) is attached as Joint Exhibit L.

4. On or about September 14, 1971, and September 15, 1972, plaintiff filed consolidated Federal income tax returns for the years ending December 31, 1970, and December 31, 1971, respectively, with the Internal Revenue Service Center at Cincinnati, Ohio. The address and Employer Identification Number on the returns were as set forth in paragraph 1. On those dates or earlier, and at later dates in accordance with adjustments agreed to with the Internal Revenue Service, plaintiff paid income tax amounting to $46,263,462 and $78,013,209 for the years ending December 31, 1970, and December 31, 1971, respectively.

5. The Goodyear Tyre & Rubber Company (Great Britain) Limited ("Goodyear England"), was, during the years in question and for all other years material to this suit, a wholly-owned subsidiary of Goodyear, incorporated in Great Britain, but was not a member of the af-

filiated group constituting the plaintiff herein. With respect to those years, Goodyear England filed income tax returns in, and paid taxes to, the United Kingdom and the Republic of Ireland, but did not file a United States tax return; it filed its tax returns on a calendar year basis and employed the accrual method of accounting in keeping its books and records and in filing its tax returns. Copies of the British tax returns of Goodyear England for 1968 through 1973 are attached as Joint Exhibits M through R. Also attached as Joint Exhibit S is a copy of one page of Joint Exhibit R.

6. Goodyear England's profit for British tax purposes, as accepted by the British taxing authorities, after allowance for all loss carryback deductions, described below, determined in accordance with British tax law, was as follows for the years indicated:

1968	£ 3,947,459
1969	1,932,178
1970	1,866,923
1971	-0-
1972	(1,397,828)
1973	(3,375,375)

7. For the purposes of the present case, the Commissioner determined that the income before taxes of Goodyear England computed under United States income tax concepts was as follows for the years indicated:

	Amount	Increase
1970	£ 3,812,473	£ 1,945,550
1971	3,224,486	3,224,486
1973	1,137,152	4,512,527

8. The increases made by the Commissioner in the computation of income under United States concepts, as set out in paragraph 7, over that under British concepts, as

set out in paragraph 6, were due to the following adjustments for the years indicated:

		1970	1971	1973
Inventory Adjustment		–	–	£ 2,152,825
Depreciation net adjustment	£	(597)	£ 1,321,681	2,380,984
Dividends		157,538	91,658	–
Group relief disallowance		–	291,762	
Not explained		–	(154,958)	–
Explanation not Agreed		–	–	(82,349)
		156,941	1,550,143	4,451,460
Agreed IRS Adjustments		8,921	26,089	61,067
Disallowance of British tax concept loss carryback from 1973		1,779,688	1,595,687	–
Irish Tax Deduction disallowed		–	52,567	–
Total		£ 1,945,550	£ 3,224,486	£ 4,512,527

9. The inventory adjustment set out in paragraph 8 arose out of the non-recognition, for United States tax concept purposes, of Section 18 of the Finance Act 1975 (a copy of which is appended in its entirety as Joint Exhibit A). Pursuant to that section, Goodyear England elected to treat its closing inventory value as reduced by an amount equal to its increase in inventory value for the year, reduced by 10 percent of its trading income for the year.

Plaintiff agrees that the special inventory relief claimed by Goodyear England, and allowed by British tax authorities under British law, would not have been allowable in the computation of U.S. income tax in the return of Goodyear England if Goodyear England had been a U.S. corporation filing a U.S. return.

10. The depreciation net adjustment set out in paragraph 8 arose out of the non-recognition, for United States tax concept purposes, of the effect of Section 42 of the Finance Act 1971, as amended by Section 67 of the Finance Act 1972 (copies of which are appended in their entirety as Joint Exhibits B and C). Under these provisions, Goodyear England was entitled to deduct and elected to deduct depreciation on the cost of machinery and equipment at the rate of 60 percent of cost for the first year with respect to assets acquired before July 19, 1971, 80 percent of cost for the first year with respect to assets acquired between July 19, 1971 and March 22, 1972, and 100 percent of cost for the first year with respect to assets acquired thereafter. The net adjustment consisted of the disallowance of depreciaton deducted under the provisions of the Birtish law in excess of an allowance which, for the purposes of this case, is agreed to be the amount of depreciation which would have been allowable if Goodyear England had been a U.S. corporation subject to United States income tax law. Plaintiff agrees that the special depreciation relief claimed by Goodyear England, and allowed by British tax authorities under British law, would not have been allowable in the computation of U.S. income tax in the return of Goodyear England if Goodyear England had been a U.S. corporation filing a U.S. return.

11. The dividend adjustment consisted of the inclusion in the income of Goodyear England of dividends from other corporations which were wholly excludable from in-

come under British law, no dividends received deduction being allowed.

12. The agreed IRS adjustment was made pursuant to a settlement of a previous case involving the plaintiff's United States income tax for the years 1970 and 1971. Under the settlement, plaintiff agreed to include in its United States income as additional dividends from Goodyear England the amounts shown in paragrah 17 below, and to include the same amounts in accumulated profits of Goodyear England in the computation of the British tax deemed paid with respect to those dividends. Having agreed to this adjustment in the settlement of the previous case, plaintiff does not contest it here.

13. The group relief disallowance consisted of the non-recognition for United States tax purposes of an election which Goodyear England was entitled to make and did make under British tax law to attribute a part of its losses to a wholly-owned subsidiary.

14. In accordance with Section 177(3A) of the Great Britain Taxes Act 1970, as modified by Section 8, paragraph 16(6) of the Finance Act 1971 and Section 18 of the Finance Act 1975, providing for a special three-year loss carryback deduction, the loss of £3,375,375 for 1973 (para. 6 above) was applied first to 1972. Because 1972 was itself a loss year, the 1973 loss was carried back to to [*sic*] reduce 1971 income and part of 1970 income in accordance with a determination agreed upon with the British taxing authorities. A copy of the British law referred to in this paragraph is reproduced in its entirety as Joint Exhibit D. The disallowance of these deductions for United States foreign tax credit purposes arose out of the Commissioner's determination that United States tax concepts should be applied to recompute the income of Goodyear England for 1973, converting its loss for that year into a profit. See paragraphs 7 and 8 above.

15. In 1975, Goodyear England filed with Inland Revenue in Great Britain its United Kingdom income tax return, known as a corporation tax computation, for the calendar year 1973, reporting the above mentioned loss of £3,375,375 to the Inland Revenue in Great Britain. Prior to the 1973 loss carryback deduction as described in paragraph 14, Goodyear England had paid income taxes eligible for tax credit in the following amounts for the years indicated:

1969	£ 833,252
1970	1,430,036
1971	702,567
1972	-0-
1973	-0-

16. For the years 1969 through 1973, Goodyear England paid cash dividends to Goodyear in the following amounts for the years indicated:

	pounds	exchange rate	dollars
1969	937,600	2.3614	2,214,049.00
1970	937,600	2.387720819	2,238,727.04
1971	703,200	2.4306666666	1,709,244.80
1972	–	-0-	-0-
1973	879,000	2.4786	2,178,689.40

17. Pursuant to the IRS Settlement described in paragraph 12 above, the following amounts are to be included in the accumulated profits of Goodyear England for the years indicated and are also to be included in plaintiff's income as additional dividends from Goodyear England for the same years:

1970	£ 8,921
1971	26,089
1972	12,054
1973	61,067

18. In its United States returns for 1970 and 1971, plaintiff claimed foreign tax credits under Section 902 of the Internal Revenue Code of 1954, as amended, for taxes deemed paid to Great Britain in the amounts of $1,255,871 and $807,124 for the years ending December 31, 1970, and December 31, 1971, respectively.

19. During 1975 and 1976, as a result of the carryback of Goodyear England's 1973 loss to the prior years 1971 and 1970, the British government made payments* to Goodyear England aggregating £650,000 on account of the loss carry-back deduction for the year 1971 and £671,599 on account of the loss carry-back deduction for 1970.

20. Because of the receipt by Goodyear England of the payments** from the British government in the amounts of £671,599 and £650,000 as described in the preceding paragraph arising out of the carryback of the 1973 loss, the Commissioner of Internal Revenue, asserting Section 905(c) of the Internal Revenue Code of 1954, redetermined the deemed foreign tax credits claimed by plaintiff in its United States tax returns for the tax years 1970 and 1971 with respect to the dividends received from Goodyear England.

21. Joint Exhibits E and F are true copies of Form 1118, Schedules A and B, filed by plaintiff with its 1970 United States Federal income tax return.

22. Joint Exhibits G and H are true copies of Form 1118, Schedules A and B, filed by plaintiff with its 1971 United States Federal income tax return.

23. The position of plaintiff with respect to the computation of foreign tax deemed paid relating to the dividends received from Goodyear England for the years 1970 and 1971 as determined under United Kingdom tax concepts is set forth in Joint Exhibit I.

* Defendant considers these tax payments from the British government to Goodyear England to be refunds of tax.

** See footnote * above.

24. Defendant's position with respect to the computation of plaintiff's foreign tax deemed paid relating to the dividends received from Goodyear England for the years 1970 and 1971 as determined under United States tax concepts is set forth is Joint Exhibit J.

25. Under date of November 21, 1980, the Commissioner of Internal Revenue timely assessed a deficiency for the year ending December 31, 1970, in the amount of $323,654 plus interest thereon in the amount of $132,611.66 and a deficiency for the year ending December 31, 1971, in the amount of $237,616 plus interest thereon in the amount of $97,359.06.

26. Exhibit K attached is a true copy of relevant portions of the report of the Appeals Office of the Internal Revenue Service with respect to the adjustments to the Plaintiff's foreign tax credit which is at issue in this case.

27. In response to the assessments described in paragraph 25, on December 3, 1980, Goodyear paid to the Internal Revenue Service Center, Cincinnati, Ohio the following amounts for the years indicated:

Year	Tax	Interest	Total
1970	$323,654.00	$132,611.66	$456,265.66
1971	237,616.00	97,359.00	334,975.06

28. On or about November 29, 1982, Goodyear filed with the Internal Revenue Service Center, Cincinnati, Ohio, for the years 1970 and 1971 timely claims for refund of the above amounts together with interest on those amounts as required by law, on the ground that Goodyear is entitled to additional foreign tax credits for foreign taxes deemed paid with respect to the dividends referred to in paragraphs 16 and 17.

29. Under date of September 30, 1983, the Regional Commissioner of Internal Revenue by certified mail issued his notice of disallowance of the claims for refund described above.

30. Goodyear instituted this proceeding in the United States Claims Court against the United States of America on September 6, 1985, to recover the $791,240.72 that Goodyear paid to the Internal Revenue Service as stated in paragraph 26, together with interest thereon as provided by law.

Respectfully submitted,

Date: Feb. 25, 1987

/s/ Stephen L. Buescher

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Date: Feb. 25, 1987

/s/ Barring Coughlin

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ATTORNEYS FOR PLAINTIFF

Date: 3/2/87

/s/ Roger M. Olsen

ROGER M. OLSEN
Assistant Attorney General

Date: March 2, 1987

/s/ Robert N. Dorosin

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ATTORNEYS FOR DEFENDANT

[JOINT EXHIBIT I (REVISED)]

COMPUTATION OF BRITISH TAX DEEMED PAID
USING BRITISH TAX CONCEPTS (IN POUNDS STERLING)

	1968	1969	1970	1971	1973
Profit before tax and before carry-back of 1973 loss (Ex. M thru R)	3,947,459	1,932,178	3,646,611	1,648,254	(3,375,375)
Adjustment to U.S. concepts	-0-	-0-	-0-	-0-	-0-
Deduction of 1973 loss carry-back (Stip. 8)	-0-	-0-	(1,779,688)	(1,595,687)	-0-
Deduction of Irish tax (Stip. 8)	-0-	-0-	-0-	(52,567)	
Profit after all losses before tax (Stip. 6)	3,947,459	1,932,178	1,866,923	-0-	
Agreed IRS adjustment (Stip. 8)			8,921	26,089	61,067
UK tax (net) (Stip. 15)	(1,752,096)	(833,251)	(758,437)	-0-	-0-
Adjusted accumulated profit	2,195,363	1,098,927	1,117,407	26,089	61,067
Dividends received by parent					
Cash	937,600	937,600	937,600	703,200	879,000
Per agreed IRS adjustment	-0-	-0-	8,921	26,089	61,067
Total Dividends for year	937,600	937,600	946,521	729,289	940,067
Allocation of Dividends					
To 1968	937,600			370,987	879,000
To 1969		937,600		161,327	-0-
To 1970			946,521	170,886	-0-
To 1971				26,089	-0-
To 1973					61,067
Dividends × Tax Divided by Profit (for 1970 and 1971)					
1970: Paid out of 1970: 946,521 × 758,437 Divided by 1,117,407 =			642,449		
1971: Paid out of 1968: 370,987 × 1,752,096 Divided by 2,195,363 =				296,081	
Paid out of 1969: 161,327 × 833,251 Divided by 1,098,927 =				122,325	
Paid out of 1970: 170,886 × 758,437 Divided by 1,117,407 =				115,988	
Paid out of 1971: 26,089 × 52,567 Divided by 26,089 =				52,567	
Tax deemed paid			642,449	586,961	

[JOINT EXHIBIT J (REVISED)]

COMPUTATION OF BRITISH TAX DEEMED PAID
USING UNITED STATES TAX CONCEPTS
(IN POUNDS STERLING)

	1970	1971	1973
Profit before Tax and Before 1973 loss (Exs. M thru R)	3,646,611	1,648,254	(3,375,375)
Adjustment to U.S. concepts (Stip. 8)	156,941	1,550,143	4,451,460
Deduction of 1973 loss	-0-	-0-	-0-
Agreed IRS adjustment (Stip. 8)	8,921	26,089	61,067
Profit after losses and before tax (Stip. 7)	3,812,473	3,224,486	1,137,152
Deduction of Irish tax (Stip. 8)		(52,567)	
Deduction of UK tax (Stip. 15 and 19)	(758,437)	-0-	-0-
Adjusted accumulated profit	3,054,036	3,171,919	1,137,152
Dividends received by parent			
Cash	937,600	703,200	879,000
Per agreed IRS adjustment	8,921	26,089	61,067
Total Dividends for year	946,521	729,289	940,067
Allocation of Dividends			
To 1968			
To 1969			
To 1970	946,421		
To 1971		729,289	
To 1973			940,067
	235,038		
		12,086	

$$\frac{\text{Dividends}}{\text{Accumulated Profit After Taxes}} \times \text{Taxes Paid} = \text{Section 902 credit (Sec. 78 income)}$$

$$1970: \frac{946,521}{3,054,036} \times 758,437 = 235,038$$

$$1971: \frac{729,289}{3,171,919} \times 52,567 = 12,086$$

[JOINT EXHIBIT M]

STATEMENT A

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

STATEMENT OF LIABILITY TO CORPORATION TAX FOR THE YEAR ENDED 31ST DECEMBER 1968

Total profit less charges on income (B)		3,984,746
Less: Group relief (note)		
Tyretreads Limited	12,859	
Direct Tyres (Chester) Limited	2,610	
Fosse (England) Limited	18,805	
Hedley Drake (Tyres) Limited	3,013	
		37,287
		£3,947,459

CORPORATION TAX PAYABLE 1ST JANUARY 1970

Financial year	
1967 (3 months) £986,865 at 42½%	419,417.12. 6
1968 (9 months) £2,960,594 at 45%	1,332,267. 6. 0
	1,751,684.18. 6
Less: Credit for Republic of Ireland Corporation Profits Tax (43)	49,674.10. 7
	1,702,010. 7.11
Add: Income tax suffered on directors fees received deducted in error in 1967 (note)	412.10. 0
	£1,702,422.17.11

Note: The group relief claimed is in respect of the subsidiaries losses for the accounting period ended 30th November 1968 in accordance with the Inspector's letter dated 21st January 1970. Goodyear's relationship with the subsidiaries was such that Goodyear is entitled to their losses for the whole of that period.

The income tax suffered on directors' fees received was recovered via the medium of the forms CT 61 for the years 1966/67 and 1967/68. The deduction in the corporation tax computation for the year ended 31st December 1967 is added back above.

STATEMENT B

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

CORPORATION TAX COMPUTATION FOR THE YEAR ENDED 31ST DECEMBER 1968

Profit after taxation		2,167,781
Add:		
Amount written off Stratton Street lease (3)	722	
Increase in general provision for bad debts (4)	14,362	
Amount written off alterations to branches less allowable expenditure (5)	10,727	
Increase in reserves for pensions of field representatives (7)	871	
Provision for consumer incentive programme (7)	8,221	
Taxation (8)	1,937,886	
Depreciation (10)	1,683,263	
Proceeds on sale of moulds (14)	800	
Disallowable items included in repairs (17)	3,067	
Disallowable items included in utilities and maintenance (23)	1,711	
Disallowable legal and professional charges (25)	2,120	
Stamp duties (29)	413	
Disallowable items included in branch repairs and alterations (32)	1,081	

Disallowable item included in repairs and alterations of retread plants (33)	234	
Disallowable subscriptions and donations (34)	1,031	
Interest expense (35)	200,717	
Disallowable items included in miscellaneous expenses (36)	177,328	
Royalties payable (37)	10,004	
Disallowable business entertaining expenses (41)	44,833	
Prior years' adjustment in respect of capital allowances and entertaining (42)	38,645	
		4,138,036
		6,305,817
Less:		
Decrease in provision for unrealised profit on sales to subsidiaries (2)	27,000	
Decrease in reserve for vacation expenses of American employees (7)	125	
Increase in revenue content of capital work in progress (12)	32,811	
Interest receivable (38)	85,853	
Deductible item included in incidental income (39)	20,233	
Dividend income (40)	157,538	
Moulds:		
Half of 1967 additions	138,989	
Half of 1968 additions (11)	121,100	
		583,649
c/fwd.		5,722,168

b/fwd.		5,722,168
Less:		
Capital allowances:		
Industrial buildings (C)		
Initial	68,356	
Writing down	109,110	
Plant etc. (D)		
Initial	38,008	
Writing down	1,385,429	
		1,600,903
Case I profit		4,121,265
Interest received (38)		75,123
Chargeable gain (F)		450
		4,196,838
Less:		
Charges on income:		
Payments under covenant (34)	768	
Interest paid (35)	201,606	
Royalties paid (37)	9,718	
		212,092
		£3,984,746
		(A)

[JOINT EXHIBIT N]

STATEMENT A

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

STATEMENT OF LIABILITY TO CORPORATION TAX FOR THE YEAR ENDED 31ST DECEMBER 1969

Total profit less charges on income (B)		2,156,300
Group relief: –		
Regional Tyre Services Limited (year to 30.11.69)	176,532	
Tyretreads Limited (year to 30.11.69)	1,703	
Transport Tyres Limited (year to 30.9.69)	937	
Progressive Tyre Sales Limited (1.4.69 to 30.11.69)	678	
Roy Swinbourne Garages (Bilston) Limited (29.4.69 to 30.11.69)	816	
J. Palmer & Son (Tyres) Limited (1.5.69 to 30.11.69)	43,456	224,122
		£1,932,178

CORPORATION TAX PAYABLE

Financial year	
1968 (3 months) £483,044 at 45%	217,369.80
1969 (9 months) £1,499,134 at 42½%	615,881.95
	833,251.75
Less: Credit for Republic of Ireland Corporation Profits Tax (37)	38,455.27
	£794,796.48

STATEMENT B

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

CORPORATION TAX COMPUTATION FOR THE YEAR ENDED 31ST DECEMBER 1969

Profit after taxation		1,695,089
Add:		
Increase in provision for unrealised profit on sales to subsidiaries (2)	5,000	
Amount written off Stratton Street lease (3)	722	
Increase in general provision for bad debts (4)	6,075	
Amount written off alterations to branches less allowable expenditure (5)	12,924	
Increase in provisions for pensions of field representatives (7)	932	
Provision for exchange losses on forward contracts for dollars (7)	16,183	
Taxation (8)	1,440,000	
Capital expenditure charged to revenue (9A)	173,861	
Depreciation (10)	1,996,584	
Decrease in revenue content of capital work in progress (12)	31,643	
Disallowable items included in retail store expenses (18)	791	
Disallowable items included in utilities and maintenance (19)	588	

Disallowable legal and professional charges (21)	5,497	
Stamp duties (25)	6,561	
Disallowable items included in branch repairs and alterations (28)	619	
Disallowable items included in repairs and alterations of retread plants (29)	2,441	
Disallowable subscriptions and donations (30)	1,208	
Interest expense (31)	193,192	
Disallowable items included in miscellaneous expenses (32)	307,506	
Royalties payable (33)	3,535	
Disallowable business entertaining expenses	44,000	
Disallowable gifts to customers	3,747	
		4,253,909
		5,948,998
Less:		
Decrease in provision for future training expenses (7)	1,157	
Decrease in provision for vacation expenses of American employees (7)	450	
Interest receivable (34)	90,437	
Deductible item included in incidental income (35)	32,327	
Dividend income (36)	157,538	
Akron service charge for 1969 (39)	237,000	

Moulds:		
Half of 1968 additions	121,099	
Half of 1969 additions (9A and 11)	229,263	
Capital allowances: –		
Industrial buildings (C) –		
Initial	168,458	
Writing down	161,735	
Balancing	275	
Plant etc: –		
Initial (D)	146,360	
Writing down (D)	2,314,377	
Additional (E)	6,392	
		3,666,868
		2,282,130
Interest received (34)		75,940
		2,358,070
Charges on income: –		
Payments under covenant (30)	916	
Interest paid (31)	194,385	
Royalties paid (33)	6,469	
		201,770
		£2,156,300
		(A)

[JOINT EXHIBIT O]

STATEMENT A

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

CORPORATION TAX COMPUTATION FOR THE YEAR ENDED 31 DECEMBER 1970

Profit after taxation		2,368,278
Add:		
Increase in provision for unrealised profit on sales to subsidiaries (2)	50,000	
Amount written off Stratton Street lease (3)	722	
Amount written off alterations to branches less allowable expenditure (5)	23,529	
General provision for redundancy payments (7)	1,000	
Increase in general provision for training expenses (1)	4,367	
Increase in provisions for pensions of field representatives (7)	983	
Taxation (4)	1,517,500	
Depreciation (10)	2,716,765	
Proceeds on sale of moulds (14)	1,119	
Capital expenditure charged to revenue (15A)	111,177	
Disallowable items included in utilities and maintenance (21)	2,836	
Disallowable legal and professional charges (23)	5,375	
Stamp duties (27)	31,049	

Disallowable items included in branch repairs and alterations (30)	4,106	
Disallowable items included in repairs and alterations of retread plants (31)	1,043	
Disallowable subscriptions and donations (32)	1,074	
Interest expenses (33)	174,714	
Disallowable items included in miscellaneous expense (34)	269,282	
Akron service charge (38)	21,516	
Disallowable business entertaining expenses (as agreed with BMIT)	44,000	
Disallowable gifts to customers	781	
		4,982,940
		7,351,218
Less:		
Decrease in general provision for bad debts (4)	34,323	
Decrease in provision for exchange difference on forward contracts for dollars (7)	12,324	
Increase in revenue content of capital work in progress (12)	1,364	
Interest receivable (35)	101,186	
Deductable items included in incidental income (36)	56,395	
Dividend income (37)	157,538	

Allowances in respect of moulds:		
One-half of 1969 additions	229,262	
One-half of 1970 additions (11 and 15A)	192,407	
Capital allowances: –		
Industrial buildings (B):		
Initial	139,492	
Writing down	164,783	
Balancing	14,817	
Plant etc (C):		
First year	65,254	
Initial (D)	55,268	
Writing down	2,256,095	
Balancing	5,531	
Additional allowances(D)	14,928	
		3,500,967
Case I profit		3,850,251
Interest received (35)		102,333
Chargeable gains less losses (E)		1,651
		3,954,235
Charges on income:		
Payments under covenant (32)	916	
Interest paid (33)	185,382	
		186,298
		3,767,937
Group relief:		
Autotyres Loughborough Limited	11,661	
Grooms Tyre Services Limited	1,426	

Master Tyre Services Limited (including Roy Swinbourne Garages' (Bilston) Limited)	14,983	
J Palmer & Son (Tyres) Limited	7,055	
Progressive Tyre Sales Limited	737	
Regional Tyre Services Limited	82,034	
Transport Tyres Limited	3,430	
		121,326
		£3,646,611
		(A)

STATEMENT A

THE GOODYEAR TYRE & RUBBER COMPANY
(GREAT BRITAIN) LIMITED

STATEMENT OF CORPORATION TAX PAYABLE
YEAR ENDED 31 DECEMBER 1970

Profit less group relief	3,646,611
Less:	
Losses carried back from year ended 31 December 1973 under S.177(3A) ICTA 1970	1,779,688
	£1,866,923

Financial year 1969	466,730	at 42.5%	198,360.25
Financial year 1970	1,400,193	at 40%	560,077.20
	£1,866,923		758,457.45
Double tax relief re Republic of Ireland corporation profits tax (39)			52,525.94
			£705,911.51

[JOINT EXHIBIT P]

STATEMENT A

THE GOODYEAR TYRE & RUBBER COMPANY
(GREAT BRITAIN) LIMITED

STATEMENT OF LIABILITY TO CORPORATION TAX FOR THE YEAR ENDED 31 DECEMBER 1971

Total profit less charges on income (B)		3,337,844
Less:		
Claim under Section 177 (2) ICTA 1970 in respect of trading loss for 1972	1,397,828	
Less:		
Group relief: –		
Master Tyre Services Limited (year to 30.11.71)	40,117	
J. Palmer & Son (Tyres) Limited (year to 30.11.71) (provisional)	138,565	
Tyretreads Limited (year to 30.11.69)	65,528	
Fullwood Tyre Services Limited (28.5.71 to 30.11.71)	19,421	
Fullwood Quality Remoulds Limited (28.5.71 to 30.11.71)	9,674	
Staffordshire Motor Tyre Company Limited (28.5.71 to 30.11.71)	18,457	
		1,689,590
		£1,648,254

STATEMENT B

THE GOODYEAR TYRE & RUBBER COMPANY
(GREAT BRITAIN) LIMITED

CORPORATION TAX COMPUTATION FOR THE YEAR ENDED 31 DECEMBER 1971

Profit after taxation (1)		3,092,697
Add:		
Amount written off Stratton Street lease (3)	723	
Increase in general provision for bad debts (4)	29,978	
Amount written off alterations to branches (5)	31,042	
Increase in provision for pensions of field representatives (7)	1,037	
Provision for vacation expenses of American employees (7)	854	
Taxation (8)	1,564,500	
Depreciation (10)	2,825,886	
Proceeds on sale of moulds (14)	1,250	
Disallowable legal and professional charges (24)	10,398	
Disallowable items included in taxes (27)	2,715	
Disallowable items included in repairs and maintenance (30)	42,716	
Disallowable business entertaining expenses (31)	42,806	
Disallowable subscriptions and donations (32)	825	

Interest expense (33)	115,485	
Disallowable items included in miscellaneous expenses (34)	141,722	
Adjustment in respect of Akron service charge (38)	215,482	
		5,027,419
		8,120,116
Less:		
Decrease in provision for exchange difference on forward contracts for dollars (7)	3,859	
Decrease in provision for consumer incentive programme (7)	2,648	
Interest receivable (35)	106,032	
Deductible item included in incidental income (36)	44,687	
Dividend income (37)	91,658	
Allowances in respect of moulds:		
One half of 1970 additions	192,406	
One half of 1971 additions (11)	183,802	
Capital allowances:		
Industrial buildings (C)		
Initial	152,810	
Writing down	177,510	
Balancing allowance on disposal of building (C)	458	

Plant (D):		
First year	1,716,525	
Writing down	2,060,714	
Additional allowance (E)	39,550	
		4,772,659
Case I profit		3,347,457
Interest received (36)		105,943
Chargeable gains less losses (F)		1,695
		3,455,095
Charges on income:		
Payments under deed of covenant (32)	683	
Interest paid (33)	116,568	
		117,251
		£3,337,844
		(A)

[JOINT EXHIBIT Q]

STATEMENT A

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

STATEMENT OF CORPORATION TAX RELIEF FOR LOSSES AND CHARGES ON INCOME FOR THE YEAR ENDED 31 DECEMBER 1972

Balance of Schedule D Case I loss (B)	£1,400,243
Surrendered by way of group relief to: Lee Tyre Co (UK) Ltd	2,415
Claim under section 177(2) against profit for the year ended 31 December 1971	1,397,828
	£1,400,243
Charges on Income	£ 111,281
Surrendered by way of group relief to: Les Tyre Co (UK) Ltd	£ 111,281

STATEMENT B

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

CORPORATION TAX COMPUTATIONS FOR THE YEAR ENDED 31 DECEMBER 1972

Profit after taxation (1)		1,202,295
Add:		
Amount written off Stratton Street lease (3)	729	
Amount written off alterations to branches (5)	32,873	
Increase in provision for pensions of field representatives (£575 + £414) (7)	989	
Increase in provisions for exchange difference on forward contracts for purchase of dollars (7)	7,585	
Increase in provision for consumer incentive programme (7)	3,216	
Taxation (8)	689,000	
Depreciation (10)	3,363,353	
Proceeds on sale of moulds (14)	9,967	
Disallowable legal and auditing (23)	13,093	
Disallowable items included in Taxes (27)	3,315	
Disallowable items included in Repairs and Maintenance (30)	6,842	
Disallowable business entertaining (31)	41,832	

Disallowable subscriptions and donations (32)	3,661	
Interest expense (33)	106,803	
Disallowable items included in miscellaneous expenses (34)	49,005	4,332,263
		5,534,558

Less:

Decrease in provision for unrealised profit on sales to subsidiaries (2)	30,000
Decrease in general provision for bad debts and credit notes (4)	35,967
Decrease in provision for vacation expenses of American employees (7)	131
Decrease in provision for redundancy payments (7)	1,000
Dividend Income (35)	91,658
Interest Income (36)	125,919
Deductible item included on incidental income (37)	32,789
Relief in respect of Irish Corporation Profits Tax (38)	34,249
Allowances in respect of moulds:	
One half of 1971 additions	183,801
One half of 1972 additions ex 1971 CWIP (balance claimable next year) (11)	252,353

Capital Allowances		
Industrial Buildings (C)		
Initial	90,125	
Writing Down	205,983	
Plant (D)		
First Year	3,362,554	
Writing Down	2,544,231	
Additional allowances as a result of re-classification of 1971 CWIP (E)		
First Year	48,900	
Initial	1,205	
		7,040,865
Case I loss subject to section 177(2) claim against profits of the same accounting period below: –		(1,506,307)
Interest received on promissory note (34)	1,000	
Interest received (36)	105,064	
Balance of Case I loss	(£1,400,243)	

Charges on income:	
Payments under deed of covenant (gross) (32)	3,949
Interest paid (33)	107,332
	£ 111,281

Note:

There are losses applicable to the Fullwood (Quality Remoulds) Limited trade totalling £1,403 carried forward.

[JOINT EXHIBIT R]

STATEMENT A

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

STATEMENT OF CORPORATION TAX RELIEF FOR LOSSES AND CHARGES ON INCOME FOR THE YEAR ENDED 31 DECEMBER 1973

Balance of Schedule D Case I loss (B)		(3,457,724)
Surrendered by way of group relief to:—		
Tyre Service Holdings Ltd (not agreed)	73,000	
Booths Tyre Services Ltd (not agreed)	5,000	
The Outra Belting & Rubber Co Ltd (part)	15,376	
Progressive Tyre Sales Ltd	3,655	
		97,032
Claim under Section 177(3A) ICTA 1970 against the profits for the year ended 31 December 1971 and 31 December 1970		
		£(3,360,693)
(Note: first year allowances at 100% total £3,395,665)		
Charges on income (B)		104,714
Surrended by way of group relief to:—		
Lee Tyre Co (UK) Ltd	89,321	
The Outra Belting & Rubber Co Ltd (balance)	15,393	
		104,714
		£ —

STATEMENT A/1

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

STATEMENT OF CLAIM UNDER SECTION 177(3A) ICTA 1970 AND CORPORATION TAX REPAYMENT ARISING

Losses available for claim under section 177(3A) ICTA 1970			£3,360,693
Relieved as follows:—			
Year ended 31 December 1971			
Profits less group relief		3,047,709	
Less: Irish corporation profits tax—double taxation relief not available	52,567		
: Claim under S177(2) ICTA 1970	1,397,828		
	1,450,395		
Claim under S177(3A) ICTA 1970	1,597,314		1,597,314
		3,047,709	
Year ended 31 December 1970			
Profits less group relief		3,646,611	
Less: Claim under S177(3A) ICTA 1970		1,763,379	1,763,379
		£1,883,232	
			£3,360,693

CORPORATION TAX REPAYABLE

Year ended 31 December 1971			
Payments made on account			650,000.00
Year ended 31 December 1970 – revised liability			
Financial year 1969	470,808 at 42.5%	200,093.40	
1970	1,472,424 at 40%	564,969.60	
	£1,883,232	£765,063.00	
Less: double taxation relief		52,525.94	
		712,537.06	
Payments made on account	1,377,500.00		
1969 overpayment offset against 1970 liability	-49,988.75		
	1,427,488.75		
			714,951.69
			£1,364,951.69
First repayment			420,000.00
Second repayment			885,707.92
			1,305,707.92
			59,243.77
Balance due			£1,364,951.69

STATEMENT B

THE GOODYEAR TYRE & RUBBER COMPANY (GREAT BRITAIN) LIMITED

CORPORATION TAX COMPUTATIONS FOR THE YEAR ENDED 31 DECEMBER 1971

Profit after taxation (1)		580,872
Add:		
Amount written off Stratton Street lease (3)	780	
Increase in general provision for bad debts and credit notes (4)	1,343	
Amount written off alterations to branches (5)	21,902	
Increase in provision for pensions of field representatives (£484 + £512) (6)	996	
Increase in provision for vacation expenses of American employees (6)	1,561	
Taxation (7)	244,489	
Depreciation (9)	3,630,047	
Proceeds on sale of moulds (13)	17,423	
Disallowable legal and audit (22)	2,705	
Disallowable items included in taxes (26)	989	
Disallowable items included in Repairs and Maintenance (29)	5,412	
Disallowable subscriptions (30)	2	
Disallowable donations (31)	2,527	

Interest expense (32)	100,558	
Disallowable items included in miscellaneous expenses (33)	84,824	
Disallowable business entertaining expenses (38)	44,445	
		4,160,403
		4,741,275
Less:		
Decrease in provision for unrealised profit on sales to subsidiaries (2)	60,000	
Deferred remould plant repairs claimed (3)	12,398	
Decrease in provision for consumer incentive programme (6)	1,641	
Decrease in provision for exchange differences on forward contracts for purchase of dollars (6)	7,585	
Investment grants on revenue expenditure (2a)	7,992	
Interest receivable (34)	254,436	
Deductible item included in incidental income (35)	25,374	
Relief in respect of Irish Corporation Profits Tax (36)	16,669	
Akron service charge adjustment (37)	(87,977)	

Allowances in respect of moulds		
one half of 1972 additions ex 1971 CWIP	252,353	
Capital allowances:		
Industrial buildings (C)		
Initial	126,923	
Writing down	209,100	
Balancing	539	
Plant etc (D)		
Initial	108,633	
First year	3,395,665	
Writing down	1,917,817	
		6,309,149
		(1,567,874)
Relief for appreciation in the value of stock and work in progress (40)		(2,152,825)
Case I loss subject to claim under S177(2) ICTA 1970 against profits of same accounting period below		(3,720,699)
Interest received (34)		262,975
Balance of Case I loss		£(3,457,724)

CHARGES ON INCOME

Payments under deed of covenant (gross) (31)		3,273
Interest paid (32)		101,441
		£104,714

Note: there are losses applicable to the Fullwood (Quality Remoulds) Limited trade totalling £1,403 carried forward.

[JOINT EXHIBIT S]

STATEMENT OF CLAIM UNDER SECTION 177(3A) ICTA 1970 AND CORPORATION TAX REPAYMENT ARISING

Losses available for claim under Section 177(3a) ICTA 1970			£3,375,375
Relieved as follows:			
Year ended 31 December 1971			
Profits less group relief		3,046,082	
Less: Irish corporation profits tax – double taxation relief not available	52,567		
Claim under S177 (2) ICTA 1970	1,397,828		
	1,450,395		
Claim under S177(3A) ICTA 1970	1,595,687	3,046,082	1,595,687
Year ended 31 December 1970			
Profits less group relief	3,646,611		
Less: Claim under S177(3A) ICTA 1970	1,779,688		1,779,688
			£3,375,375

CORPORATE TAX REPAYABLE

Year ended 31 December 1971				650,000.00
Payments made on account				
Year ended 31 December 1970				
Financial year 1969	466,730 at 42.5%		198,360.25	
1970	1,400,193 at 40%		560,077.20	
	£1,866,923		£758,437.45	
Less: double taxation relief			52,525.94	
			705,911.51	
Payments made on account		1,377,500.00		
1969 overpayment offset against 1970 liability		49,988.75	1,427,488.75	721,577.24
				£1,371,577.24
First repayment – March 1975				420,000.00
Second repayment – April 1975				885,707.92
Third repayment – June 1975				54,000.00
Fourth repayment – August 1975				8,000.00
				1,367,707.92
Balance due				– 3,869.32
				£1,371,577.24

In the Supreme Court of the United States

No. 88-1474

UNITED STATES, PETITIONER

v.

GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES

ORDER ALLOWING CERTIORARI. Filed May 1, 1989.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Federal Circuit is granted.

May 1, 1989

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No. 88-1474 (4)

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether the term "accumulated profits" in the foreign tax credit provisions of Section 902 of the Internal Revenue Code means income or profits as defined by the tax law of the United States or, instead, as defined by the tax law of a foreign country.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is reported at 856 F.2d 170. The opinion of the Claims Court (Pet. App. 9a-28a) is reported at 14 Cl. Ct. 23.

JURISDICTION

The judgment of the court of appeals (Pet. App. 29a) was entered on August 31, 1988. A petition for rehearing was denied on November 8, 1988 (Pet.

App. 31a). On January 25, 1989, the Chief Justice extended the time within which to petition for a writ of certiorari to and including March 8, 1989. The petition was filed on that date, and was granted on May 1, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Sections 316, 901, and 902 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.902-3 of the Treasury Regulations on Income Tax (26 C.F.R.), as in effect for 1970 and 1971, are set forth in pertinent part in a statutory appendix (App., *infra*, 1a-4a).

STATEMENT

1. This case involves the foreign tax credit applicable to the federal taxation of dividend income received by a United States corporation from its foreign subsidiary. When a foreign subsidiary distributes all or part of its profits to its domestic parent, that distribution generally is taxable to the parent as a dividend under the provisions of Sections 301 and 316 of the Internal Revenue Code.[1] If those profits have already been subjected to income tax by the foreign country where they were earned, simple taxation as a dividend by the United States would result in double taxation.[2] Accordingly, Sections

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect during 1970 and 1971, the years at issue (the Code or I.R.C.).

[2] The deduction for intercorporate dividends allowed by Section 243 of the Code is applicable only to dividends received from domestic corporations.

901(a) and 902(a)(1) of the Code allow the parent (if it owns at least 10% of the voting stock of the foreign subsidiary) to take an "indirect" or "deemed paid" credit against its United States income tax to reflect income tax paid by the subsidiary to a foreign country.

The situation is complicated somewhat when, in a particular year, the foreign subsidiary does not distribute all of its profits to its parent, but instead retains some of the profits and adds them to surplus. In that event, giving the parent a full credit for all of the foreign income tax paid by the subsidiary would overcompensate for the double taxation risk—and thus give the taxpayer a windfall—because the parent is not receiving all of the subsidiary's profits as a dividend subject to United States income tax. Therefore, the Code allows the parent to take a credit against the income tax payable to the United States for only a prorated portion of the foreign income taxes paid by the subsidiary. See generally *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942).

Section 902(a)(1) provides for the computation of the allowable credit as follows: "to the extent such dividends are paid by such foreign corporation out of accumulated profits," the parent is "deemed to have paid the same proportion of any income * * * taxes paid * * * by such foreign corporation to any foreign country * * * on or with respect to such accumulated profits, which the amount of such dividends * * * bears to the amount of such accumulated profits in excess of such * * * taxes." In other words, the allowable prorated credit is computed by multiplying the foreign income taxes paid by a fraction—namely, the ratio of the dividends to the subsidiary's (after-tax) accumulated profits. This computation

is illustrated by the following equation (see Pet. App. 4a, 15a n.6):[3]

$$\text{Foreign taxes paid} \times \frac{\text{Dividends}}{\text{Accumulated profits minus foreign taxes}} = \S\,902 \text{ credit}$$

The issue in this case is the meaning of the term "accumulated profits"—specifically, whether it refers to the subsidiary's profits as computed under United States tax law or under the tax law of the foreign country.[4]

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[3] This Court described this equation in narrative form in *American Chicle*, stating that the foreign taxes are multiplied by a fraction, of which "[t]he numerator is the dividends received by the parent [and] [t]he denominator is the 'accumulated profits' of the subsidiary" (316 U.S. at 452); the statute was later amended to require the subtraction of foreign taxes from the denominator (see note 10, *infra*). The operation of the proportional credit can be illustrated by some simple examples. If a foreign subsidiary earns $100 of profits, pays $20 in foreign income taxes and distributes the remaining $80 to its parent as a dividend, the parent is entitled to the full $20 credit ($20 × $80/($100-$20)). If, however, the subsidiary distributes only $40 of its after-tax profits to its parent, the allowable credit will be halved to $10 ($20 × $40/($100-$20)). The allowable credit can also be affected by a change in the denominator of the fraction. If the subsidiary pays the same $20 in foreign income taxes and distributes the same $80, but the "accumulated profits" are determined in a different manner and found to be $180, the allowable credit will also be halved to $10 ($20 × $80/($180-$20)).

[4] The statutory definition of "accumulated profits" does not specifically address this question. It defines the term for purposes of Section 902 as "the amount of [the corporation's] gains, profits, or income computed without reduction by the amount of the income * * * taxes imposed on or with respect to such profits or income" (I.R.C. § 902(c)(1)). The definition further provides that the Commissioner has the "full power to determine from the accumulated profits of what year

2. Respondent is an affiliated group of domestic corporations that file consolidated federal income tax returns. The parent of the group (Goodyear U.S.) owns all of the stock of a British subsidiary (Goodyear U.K.) that does not join in the consolidated return. The subsidiary reported net income on its British tax returns for 1970 and 1971, paid taxes to Britain on that income, and distributed dividends to its parent. On the United States consolidated tax returns for 1970 and 1971, respondent claimed Section 902 foreign tax credits with respect to the foreign tax paid for those years by the British subsidiary. On its 1973 British tax return, however, the subsidiary reported a loss (attributable to accelerated depreciation and special inventory adjustments), which it carried back to offset virtually all of its income for 1971 and part of its income for 1970. As a result of this loss carryback, Britain refunded almost all of the income tax paid for 1971 and part of the tax paid for 1970. The 1973 loss deductions, although

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or years such dividends were paid," generally "treating dividends as having been paid from the most recently accumulated gains, profits, or earnings" (*ibid.*). The credit thus is computed by considering the subsidiary's accumulated profits on an annualized basis. A dividend payment is allocated first to the accumulated profits of the most recent year and then, if those profits are insufficient to cover the amount of the dividend, to the profits of the next most recent year, and so forth. The credit is then computed separately for each year to which the dividend is traced (or "sourced") by multiplying the foreign income tax paid for that year by the appropriate fraction. The sum of those separate annual computations yields the Section 902 credit for the particular dividend. See *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. 53, 78-83 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974); *General Foods Corp.* v. *Commissioner*, 4 T.C. 209, 215 (1944).

recognized under British law, would not be allowable in computing income under the Internal Revenue Code. Pet. App. 1a-2a, 10a-11a.

Following the payment of the British tax refunds, the Commissioner audited respondent's consolidated returns for 1970 and 1971 and recomputed the foreign tax credits under the authority of Section 905(c) of the Code, which requires the redetermination of a foreign tax credit after a refund of any of the foreign tax paid. The Commissioner reduced the creditable foreign taxes to reflect the refund, but made no adjustment to the British subsidiary's "accumulated profits," which he determined must be computed under principles of United States tax law and therefore were unaffected by the 1973 loss and resulting carryback not allowable under the Internal Revenue Code. Under this analysis, the subsidiary's profits for 1970 and 1971 were adequate to cover the dividends paid in those years, and the Commissioner treated the dividends as having been derived from the accumulated profits for the years of distribution. Because the foreign tax paid in those years (after taking into account the refund) was relatively small, the Section 902 credit for those years allowed by the Commissioner was correspondingly small. He asserted deficiencies in respondent's income tax of $323,654 for 1970 and $237,616 for 1971. Pet. App. 2a-3a & n.3, 11a-12a, 23a-24a.

Respondent paid the deficiencies and, after its administrative refund claim was denied, brought this refund action in the Claims Court. It contended that, for purposes of computing the prorated credit, the "accumulated profits" must be based on the British definition of taxable income. Respondent therefore adjusted that figure to account for the loss carryback peculiar to British law. This adjustment

eliminated almost all of the subsidiary's accumulated profits for 1971 and reduced them for 1970. The result was a substantially larger Section 902 credit for respondent for 1970 and 1971, and therefore a correspondingly smaller United States income tax liability, than when the Commissioner had computed "accumulated profits" based on the United States definition of taxable income. Pet. App. 3a, 15a-16a.[5]

3. On cross-motions for summary judgment, the Claims Court held for the government, ruling that "accumulated profits" in Section 902 means income or profits as defined by the Internal Revenue Code, not by the tax law of a foreign country (Pet. App. 9a-28a). The court found that this conclusion was strongly supported by Tax Court precedent (*id.* at 16a-19a) and by the language (*id.* at 19a-21a), purpose (*id.* at 22a-25a), and consistent administrative interpretation (*id.* at 25a-26a) of Section 902. With respect to the statute itself, the court explained that the dividends in the numerator of the Section 902 fraction are undeniably computed under United States law (Pet. App. 20a) and that the "accumulated profits" in the denominator are "the fund from

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[5] The tax advantage was achieved by respondent in two related ways. First, the reduction in accumulated profits in 1970 correspondingly increased the ratio of dividends to profits for that year, thereby allowing respondent to take a credit for a higher proportion of the 1970 British tax. Second, because the accumulated profits for 1971 were virtually eliminated, those profits were not sufficient to cover the dividend paid in that year. Accordingly, under the annualization principle of Section 902 (see note 4, *supra*), part of the 1971 dividend was attributed to profits earned in preceding years going back to 1968. Because the foreign taxes for those years were much higher than the almost nonexistent tax of 1971, respondent's allowable Section 902 credit was increased. Pet. App. 23a-24a; J.A. 30.

which the dividends are paid" (*id.* at 21a). Therefore, the court concluded, it would introduce an inconsistency that would impair the proper functioning of the allocation formula if United States law is not also used to compute the profits in the denominator (*ibid.*).

Based on the legislative history, the Claims Court identified three principal purposes of the Section 902 credit: (1) to provide equal treatment for unincorporated foreign branches and foreign subsidiaries; (2) to eliminate double taxation; and (3) to limit the allowable credit for foreign taxes paid by a subsidiary when only a portion of its profits is distributed as a dividend. Pet. App. 23a. The court found that its interpretation "effectuates congressional intent" (*ibid.*) in furthering these policies, whereas respondent's interpretation would frustrate them. In particular, the court rejected respondent's contention that defining "accumulated profits" in terms of United States law would lead to double taxation in this case. The court explained that the relatively small credit that respondent receives under the court's interpretation is a direct result of the fact that its subsidiary paid very little British income tax for 1970 and 1971. *Id.* at 24a. The court concluded (*ibid.*): "To not recognize this fact as [respondent] urges would eviscerate the very purpose of the pro-rata credit and permit [respondent] a substantial windfall in avoiding other taxes with the phantom taxes deemed paid."

Finally, the court found that its holding was supported by the longstanding administrative construction embodied in Treas. Reg. § 1.902-3(c)(1) (1971 ed.). That regulation explicitly defines the phrase "accumulated profits" in Section 902 in terms of

"earnings and profits," which are the source of dividends under Section 316 of the Code and which are computed under United States law. The court concluded that this administrative construction is "consistent with the purposes enunciated by Congress when enacting the indirect tax credit legislation" (Pet. App. 26a).

4. The court of appeals reversed (Pet. App. 1a-8a). The court held that the "plain meaning" of Section 902 requires the conclusion that "accumulated profits" be determined by applying the tax law of the foreign country (*id.* at 6a). The court stated that the text of Section 902(a)(1) describes the creditable foreign taxes as those paid "on or with respect to the accumulated profits of such foreign corporation," and that Section 902(c) uses similar language (Pet. App. 5a (quoting the 1982 version of Section 902) (emphasis omitted)). The court concluded from this phrasing that "accumulated profits" must be "the actual basis on which the foreign sovereign assesses tax liability," *i.e.*, foreign taxable income as determined by foreign revenue laws (*id.* at 6a). The court also concluded that its interpretation is necessary to implement the statutory goal of preventing double taxation, stating that determining "accumulated profits" under United States law would defeat this goal by "severing the relationship" between the foreign taxes paid by the subsidiary and the accumulated profits with respect to which those taxes are paid (*ibid.*). The court rejected the Tax Court precedent relied upon by the Claims Court as "fail[ing] to address the controversy raised in the instant case" (*id.* at 7a), and it did not discuss at all the Treasury Regulation that defines "accumulated profits" under Section 902 in terms of "earnings and profits."

SUMMARY OF ARGUMENT

A. The basic function and purpose of Section 902 are to avoid double taxation by allowing the domestic parent of a foreign subsidiary a foreign tax credit on its United States income tax return. This indirect credit is designed to reflect the foreign tax already paid by the subsidiary on the portion of its income that is distributed as a dividend to the parent. When all of the income of the subsidiary is so distributed, the parent should be entitled to a credit for all of the foreign tax paid. When only a portion is so distributed, however, and the rest is retained by the subsidiary as surplus, the Section 902 apportionment formula is intended to limit the credit to the portion of the foreign tax paid that is attributable to the distributed earnings—those "paid * * * out of accumulated profits." For this apportionment to work properly, the statutory ratio ("dividends" to "accumulated profits" less foreign taxes) must reflect the ratio between the actual dividends paid and the pool of potential dividends, *i.e.*, the maximum earnings of the foreign subsidiary that would be taxed as dividends if distributed to the parent.

Dividends are defined as distributions paid out of "earnings and profits," and it is well settled that the term "earnings and profits" is defined by principles of United States law (see I.R.C. §§ 312, 316). Therefore, the pool of potential dividends contained in the Section 902 apportionment formula (*i.e.*, "accumulated profits") must be defined in terms of United States tax principles. Indeed, the unworkability of the Section 902 apportionment formula under the court of appeals' interpretation is further shown by the fact that, if "accumulated profits" are defined in terms of foreign law principles to be higher than

under United States rules, the parent typically would not be allowed the full credit in cases where the subsidiary distributes its entire pool of potential dividends. In short, the use of United States law to determine "accumulated profits" is required to correlate the numerator of the Section 902 fraction (the actual dividends) with the denominator of the fraction (the potential dividends), thereby providing a coherent ratio by which to determine the foreign tax that relates to the distributed portion of the subsidiary's total earnings.

B. One of the dominant concerns motivating Congress in its enactment, and later revisions, of the indirect credit of Section 902 has been the desire to provide domestic corporations that operate through a separately incorporated foreign subsidiary with the same relief from double taxation as is provided to companies with an unincorporated foreign branch. That statutory policy would be seriously undermined by the interpretation of the court of appeals. A foreign branch has no separate tax status and therefore a domestic company with a foreign branch is required to report all of the branch's income on its United States tax return. It is then granted a "direct" credit by Section 901 for foreign taxes paid with respect to that income. Foreign concepts of taxable income have no bearing on whether the earnings of the branch are recognized on the return of the domestic "parent"; those earnings, like any other earnings of the parent, are included in its income according to United States principles of taxation. To maintain the tax treatment of the two types of business arrangements on an equal footing, the accumulated profits of a foreign subsidiary must approximate the income that would be reported by the parent were it conducting operations

through a branch. Otherwise, the two arrangements will yield different treatment even where a subsidiary distributes all of its available earnings and profits as a dividend (which is essentially equivalent to the direct attribution of income to the domestic company in the branch situation). Thus, the "accumulated profits" of a foreign subsidiary must be computed under United States law, just like the income of a foreign branch.

C. The Treasury has consistently ruled that "accumulated profits" in Section 902 are computed according to United States tax principles. This reading of the statute was first contained in a ruling issued in 1933, and it was embodied in a formal regulation in 1965. Considerable deference is due to this long-standing administrative interpretation, which also has been approved by the Tax Court for many years and by Congress when it amended Section 902 in 1986. Moreover, this interpretation accords with the general principle that, in the absence of an express indication to the contrary, Congress intended that provisions of the Internal Revenue Code would be construed under United States law rather than under unfamiliar and highly variable concepts of foreign law. See *Biddle* v. *Commissioner*, 302 U.S. 573 (1938).

D. The court of appeals' reliance on the "plain meaning" of Section 902 is erroneous. The clause on which the court rested its analysis was designed to make clear that the foreign taxes that are the starting point for computing the credit are those paid with respect to the income of the subsidiary actually available for distribution as dividends. Thus, this clause suggests that "accumulated profits" should accord with "earnings and profits," which are defined in

terms of United States law. Moreover, the statutory phrase "dividends * * * paid * * * out of accumulated profits" also suggests identification of the term "accumulated profits" with the pool of potential dividends determined under United States law. Accordingly, there is no "plain meaning" of Section 902 that supports the court of appeals' interpretation.

Nor does that interpretation advance the statutory policy of preventing double taxation. The fact that respondent's credit on its 1970 and 1971 tax returns is reduced when "accumulated profits" are determined under United States law is a logical consequence of the fact that respondent's subsidiary paid little foreign tax in those years as a result of the loss and carryback available only under British law. Because most of the "earnings and profits" distributed by the subsidiary had escaped British tax owing to the loss carryback, they were taxed *for the first time*, not the second, when included in respondent's United States income. By contrast, respondent seeks a substantial windfall through ignoring these untaxed profits and instead treating the dividends in question as distributions of profits earned in prior years when the subsidiary paid higher taxes to Britain—profits that had yet to be distributed to respondent under the principles of Sections 312 and 316 of the Code.

ARGUMENT

THE TERM "ACCUMULATED PROFITS" IN SECTION 902 OF THE CODE MEANS INCOME OR PROFITS AS DEFINED BY THE TAX LAW OF THE UNITED STATES, NOT AS DEFINED BY THE TAX LAW OF A FOREIGN COUNTRY

Section 902 of the Code specifies the amount that a United States corporation may credit against its United States income tax for foreign taxes paid by its subsidiary. The court of appeals in this case held that the term "accumulated profits" in that provision of the United States tax laws must be defined in terms of the tax law of the foreign country. This counterintuitive conclusion—reached without any recognition by the court of its inconsistency with a long-standing administrative interpretation and a Treasury Regulation directly in point—is antithetical to the basic design of the statute and undermines its purposes.

Section 902 computes the allowable foreign tax credit by allocating the foreign tax paid to the portion of the foreign-sourced income that is being reported on the United States income tax return. This allocation is based on the ratio between the dividends received by the domestic parent and the "accumulated profits" of the subsidiary from which the dividends are paid. The amount of "dividends" to be included in the income of the United States parent is determined by United States tax law; it depends in the first instance upon the existence and amount of the subsidiary's "earnings and profits" as determined by Section 312 of the Code, and then upon the extent to which the distribution was paid out of those "earnings and profits" as determined under Section 316. The logic of the statutory allocation formula is de-

stroyed, however, if United States law is used to measure the dividends, but foreign law is used to compute the "accumulated profits" of the subsidiary out of which the dividends are paid; moreover, the use of such an unbalanced ratio would lead to irrational results and disparities not intended by Congress.

The decision below also undermines the statutory goal of avoiding discrimination between domestic companies that operate abroad through unincorporated foreign branches and those that operate through separately incorporated foreign subsidiaries. Since the profits of a foreign branch are determined under United States law, the accumulated profits of a foreign subsidiary must be similarly computed in order to provide the domestic companies with the same relief from double taxation regardless of the manner in which they operate their foreign business. Thus, the decision of the court of appeals is erroneous and would significantly disrupt the proper operation of the foreign tax credit provisions of the Internal Revenue Code.

A. Because The Dividends Taken Into The Income Of The United States Parent Are Defined In Terms Of United States Tax Principles, The Term "Accumulated Profits" In Section 902 Must Also Be Defined In Terms Of United States Law In Order To Make The Statutory Allocation Formula Coherent

1. *"Accumulated Profits" Describes the Fund out of Which the Dividends Reported as United States Income Are Paid*

The term "accumulated profits" was introduced into the ratio for computing the indirect foreign tax credit by Section 238(e) of the Revenue Act of 1921, ch. 136, 42 Stat. 259. This Act was designed to cor-

rect a major flaw in the original indirect foreign tax credit provisions contained in Section 240(c) of the Revenue Act of 1918, ch. 18, 40 Stat. 1082. The 1918 statute computed the credit based on the ratio of the dividends received by the domestic company to the foreign subsidiary's "total taxable income" for that year. This provision failed to achieve its purpose of relieving double taxation in cases where the profits of a foreign subsidiary were distributed in a different year from that in which they were earned. For example, if the subsidiary made no profit and paid no foreign tax for a particular year, yet issued a dividend out of surplus accumulated during a prior year for which it had paid a foreign tax, the 1918 statute would not have allowed any credit because there was no foreign tax paid in the year of the distribution. The statute contained no mechanism to attribute or "source" the dividend to the prior year's accumulated earnings or to provide a credit for tax paid in other years on the profits that were the source of the dividend. As this Court explained in *American Chicle Co.* v. *United States*, 316 U.S. 450, 453 (1942), "[t]he difficulty with [the statute] was that it did not relate the credit to the accumulated profits or surplus of the subsidiary *out of which the dividends were paid*" (emphasis added).

Thus, in amending the statute in 1921, Congress needed to describe the total earnings of the foreign corporation, past and current, which are the source from which dividends can be declared, and then to allow a credit for the foreign taxes already paid upon the distributed portion of those earnings. To accomplish this, Congress chose the term "accumulated profits," an ordinary accounting term that includes earnings of prior years as well as current earnings,

and substituted it for "total taxable income" throughout the statute. As a result, the amended provision described the creditable foreign taxes as those "paid * * * upon or with respect to the accumulated profits * * * from which such dividends were paid," and it directed computation of the credit by multiplying those foreign taxes by the ratio of the "dividends" to the "accumulated profits." Sec. 238(e), 42 Stat. 259. The statute thus established a two-step process for determining the allowable credit: first, the maximum credit is fixed by ascertaining the foreign taxes paid upon the pool of profits that are the potential source of dividends; second, the allowable credit is limited to the proportion of the maximum credit that the dividends actually distributed bear to the total pool of profits.[6] The result of this process is a credit in the amount appropriate to prevent double taxation of the dividends received. In the words of this Court, the statute was designed "to permit identification of the accumulated profits of each taxable year out of which the dividend might have been paid and to give credit for a proportion of the subsidiary's taxes attributable to such accumulated profits." *American Chicle Co.* v. *United States*, 316 U.S. at 454.

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[6] As we have stated (see note 4, *supra*), this matching of the dividends to the accumulated profits is done on a year-by-year basis. The 1921 statute vested the Commissioner with full power "to determine from the accumulated profits of what year or years such dividends were paid," generally "treating dividends as having been paid from the most recently accumulated gains, profits, or earnings." That authority was continued unchanged in the version of the statute applicable here. See I.R.C. § 902(c) (1).

The essential features of the 1921 statute have been carried forward into the foreign tax credit provisions of Section 902 applicable here. The statute permits a domestic company to claim a prorated credit with respect to dividends received from a foreign subsidiary "to the extent such dividends are paid by such foreign corporation out of accumulated profits" (I.R.C. § 902(a)(1)). The basic apportioning fraction remains the ratio of "dividends" to "accumulated profits," and the accumulated profits continue to represent the fund of earnings, current and historic, from which the dividends are paid. As the Tax Court explained in *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. 53 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974), the credit is allowed "in respect of foreign taxes paid on the 'accumulated profits' of a particular year to the extent that dividends are paid 'out of' the accumulated profits of such year" (59 T.C. at 87-88). The statute thus designates the accumulated profits as the "source" of the distributions by the subsidiary that are taxed in the United States as dividends to the parent (see *id.* at 87 n.19).

2. *The Apportionment Formula of Section 902 is Incongruous unless "Accumulated Profits," like Dividends, Are Determined under Principles of United States Law*

Section 316 of the Code provides that distributions to shareholders from a corporation's "earnings and profits" are "dividends"; if a distribution exceeds the available "earnings and profits," however, the excess is not a dividend but rather a return of capital (I.R.C. § 301(c)). Section 312 of the Code, in turn, provides a detailed set of rules that govern the computation of "earnings and profits."[7] When a foreign subsidiary makes a distribution to its domestic parent, as in this case, it is fundamental that these provisions of United States law apply to the earnings and profits of the foreign corporation to determine the extent to which that distribution is to be treated as a "dividend" to the parent for United States tax purposes.[8] See, *e.g.*, *Untermyer* v. *Commissioner*, 24 B.T.A. 906 (1931), aff'd, 59 F.2d 1004 (2d Cir.), cert. denied, 287 U.S. 647 (1932).

It is similarly clear that the term "dividend" in Section 902 must be defined in the same manner, *i.e.*, that the amount of the dividend used in the apportionment formula is the same as that reported by the parent as dividend income under the rules of Sections 312 and 316. See Treas. Reg. § 1.902-1(a)(6); see also, *e.g.*, *H.H. Robertson Co.* v. *Com-*

[7] This Court has addressed the complexities of the computation of earnings and profits on several occasions. See *Commissioner* v. *Phipps*, 336 U.S. 410 (1949); *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496 (1948); *Commissioner* v. *Munter*, 331 U.S. 210 (1947); *Commissioner* v. *Wheeler*, 324 U.S. 542 (1945); *Foster* v. *United States*, 303 U.S. 118 (1938); *Helvering* v. *Canfield*, 291 U.S. 163 (1934); *Mason* v. *Routzahn*, 275 U.S. 175 (1927).

[8] For example, if a foreign subsidiary earned $500 in "earnings and profits" and distributed that $500 to its domestic parent, the parent would recognize $500 in dividend income on its United States return. If the foreign country allowed a $500 deduction not available in the United States and therefore the subsidiary's profit computed under foreign law was zero, that would not change the treatment on the parent's United States income tax return. Because the $500 distribution came out of "earnings and profits" as defined in the Internal Revenue Code, it would be a dividend, not a return of capital, regardless of the foreign country's definition of income.

missioner, 59 T.C. at 86; *Central Aguirre Sugar Co.* v. *Commissioner*, 24 T.C. 630, 636-638 (1955); *National Carbon Co.* v. *Commissioner*, 2 T.C. 57, 61 (1943). The intent of the indirect credit is to prevent double taxation of the "dividends" that the domestic parent receives from the subsidiary and must treat as taxable on its United States return. Therefore, the foreign tax must be apportioned to the domestic parent based on the amount of those dividends. This can be accomplished only if the term "dividends" in the numerator of the Section 902 fraction has the meaning assigned to it by Section 316 of the Code, which depends on the corporation's "earnings and profits." In sum, the phrase "dividends * * * paid * * * out of accumulated profits," which describes the numerator of the apportionment fraction in Section 902(a)(1), must be read in the same way as the phrase "distribution of property * * * out of its earnings and profits" in Section 316; it is defined solely in terms of United States law.

The Claims Court thus correctly concluded that the use of foreign law to define accumulated profits would destroy the "[al]gebraic consistency" of Section 902 (Pet. App. 21a) and would prevent the statute from working properly to eliminate double taxation. As we have explained, the concept of "accumulated profits" was introduced into the predecessor of Section 902 to represent the source of the dividend payments that are being subjected to United States income taxation. Thus, the "accumulated profits" in the denominator of the Section 902 fraction, like "earnings and profits," simply represent the fund of earnings, past and present, out of which the dividends are paid. The total accumulated profits form a pool of potential dividends, *i.e.*, the maximum

earnings of the subsidiary that would be taxed as dividends if distributed to the parent. The allocation formula is designed to limit the credit according to the proportion of those total profits that are actually distributed as dividends. Just as United States tax principles determine whether the subsidiary's actual distribution is taxed as a dividend in the hands of the parent, so too United States tax principles must determine what is the maximum amount of the subsidiary's earnings that could be distributed as a dividend, *i.e.*, the "accumulated profits." It is therefore necessary that "accumulated profits" be determined under principles of United States law in order to correlate the numerator of the Section 902 fraction (the actual dividends) with its denominator (the potential dividends), and thereby provide a coherent ratio by which to compute the share of foreign tax that relates to the distributed portion of the subsidiary's total income.

The ways in which the court of appeals' interpretation of Section 902 would disrupt—indeed, distort—the proper functioning of the credit can be illustrated by the simple examples provided above (see note 3, *supra*). If the foreign subsidiary earns \$100 of profit for the taxable year (as determined under the Internal Revenue Code), pays foreign tax of \$20 for the year, and distributes its net profit of \$80 to its domestic parent as a dividend, the parent is entitled to the full \$20 credit (\$20 x \$80/(\$100 - \$20)). This result is obviously correct; when the subsidiary distributes to the parent all of the funds available for dividends, *i.e.*, its entire net profit, the parent should be entitled to a credit for all of the foreign taxes paid. This result is achieved, however, only if "accumulated profits" are defined under United States

law. If, on the same facts, the foreign country does not allow an $80 deduction that is permitted by United States law and therefore the "accumulated profits" determined under foreign law would be $180, application of the court of appeals' interpretation would halve the parent's credit to $10 ($20 x $80/($180-$20)), even though the parent took into income 100% of the amount of earnings available for distribution as a dividend. Similarly, if the foreign country allows a $40 deduction that is not allowed by United States law and if the subsidiary distributes only $40, the parent would be entitled to the full amount of the available credit ($20 x $40/($60-$20)), even though it received (and was being taxed upon) only half of the subsidiary's net earnings available for dividend distribution with respect to that year's operations. Thus, the court of appeals' approach, in attempting to apportion the credit without consideration of the fund of potential dividends out of which the distribution is made, would reintroduce the very kind of "eccentric results" that the 1921 legislation was designed to eliminate (see *American Chicle Co.* v. *United States*, 316 U.S. at 453).[9]

The above analysis is supported by this Court's holding in *American Chicle* itself. The Court there

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[9] See 1 E. Owens & G. Ball, *The Indirect Credit* 162 (1975):

> After all the profits of a year have been distributed, the quantity used in the numerator of the fraction, "dividends," must be the same as the amount used in the denominator, "net profits." Otherwise, the amount of indirect credit will be either more or less than the amount of the foreign tax actually paid. In short, the section 902 allocation fraction functions properly only when the definition of dividends (aggregate) and net profits is exactly the same.

construed the very phrase upon which the court of appeals relied (see Pet. App. 6a)—taxes "paid * * * with respect to the accumulated profits" of the subsidiary (see 316 U.S. at 451). At that time, the predecessor of Section 902 defined "accumulated profits" as after-tax profits. The question presented was not the meaning of that term, but rather the meaning of the entire "taxes paid" clause—whether the foreign tax that is the starting point for computing the credit should be the total tax paid on the subsidiary's pre-tax profits or instead a smaller amount reflecting the proportion of total tax attributable to the after-tax profits. The Court agreed with the government that Congress had intended the latter result.[10] The Court explained (*id.* at 452-453):

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[10] The precise dispute in *American Chicle* can be illustrated by an example. If the subsidiary had $200 in income and paid foreign tax of $20, it would have had $180 in "accumulated profits" as then defined. If the subsidiary had distributed the $180 as a dividend, the taxpayer's position in *American Chicle* was that it would be entitled to a $20 credit. The Court rejected that position, however, finding that $20 was the amount of taxes paid on the subsidiary's pre-tax income, not the amount paid "with respect to the accumulated profits" of $180. Thus, under the so-called *American Chicle* limitation, the taxpayer was entitled to a credit of only $18, the foreign tax apportionable to the $180 of accumulated profits.

In 1962, Congress amended Section 902 to accomplish a similar result by redefining "accumulated profits" as the pre-tax income of the subsidiary, but at the same time adding Section 78 of the Code, which requires the parent to take into income ("gross-up") the amount of the allowable foreign tax credit. Under that approach, applicable for the tax years at issue in this case, the credit is first computed without the *American Chicle* limitation, but this change is offset by treating the credit itself as income to the parent. See, *e.g.*, *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. at 77 & n.13. Con-

> If, as is admitted, the purpose is to avoid double taxation, the statute, as written, accomplishes that result. The parent receives dividends. Such dividends, not its subsidiary's profits, constitute its income to be returned for taxation. The subsidiary pays tax on, or in respect of, its entire profits; but, since the parent receives distributions out of what is left after payment of the foreign tax,—that is, out of what the statute calls "accumulated profits," it should receive a credit only for so much of the foreign tax paid as relates to or, as the Act says, is paid upon, or with respect to, the accumulated profits.

The lesson of *American Chicle* is that the benchmark for computing the prorated Section 902 credit is the maximum amount of the subsidiary's earnings available for distribution as dividends. Amounts that are not available for distribution as dividends are not relevant in making the proration. Thus, in *American Chicle*, the amount of the subsidiary's earnings paid as foreign taxes would never be available for distribution as dividends; hence, the amount of foreign tax attributable to those earnings was not creditable. Correspondingly here, the amount of the subsidiary's income computed under foreign law principles does not define the maximum amount available for distribution as a dividend. To the extent the income under foreign law differs from that calculated under United States law, the difference has no bearing on the maximum amount of earnings that would be taxed as a dividend upon distribution to the parent in the United States. It is that figure, the "earnings and profits" of the subsidiary as computed under United States law, that logically must be the point of reference for determining the allowable portion of the credit.[11]

In sum, the statutory design is that the allowable credit shall be the proportion of the foreign tax that the dividends actually received bear to the potential dividends. That approach confines the credit to the amount necessary to prevent double taxation. It can be implemented only if "accumulated profits" are computed under United States law so that they equal the fund of potential dividends out of which the actual dividends are paid.

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gress otherwise intended no change to the applicable apportioning fraction under Section 902. As both the House and Senate Reports on the 1962 Act make clear, "[t]he result is to continue * * * the use of the ratios under existing law, but because of the amendment * * * the amount against which the ratios operate is increased [by removing the *American Chicle* limitation]." H.R. Rep. No. 1447, 87th Cong., 2d Sess. A79-A80 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 223 (1962). This adjustment was necessary to achieve maximum parity between the tax treatment of foreign branches and foreign subsidiaries. See pp. 26-32, *infra*; B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 17.11, at 17-45 to 17-47 (5th ed. 1987).

[11] This is not to say that the concepts of "accumulated profits" and "earnings and profits" are in every respect identical. Accumulated profits under Section 902 are computed on a year-by-year basis, while earnings and profits are computed on both a current basis and an aggregate historical basis (Section 316(a) provides that a dividend may be paid out of current earnings and profits even if there is a deficit in the historical earnings account). See generally Pet. App. 26a n.8; *H.H. Robertson Co.* v. *Commissioner*, *supra*, 59 T.C. at 78-79. But Section 902 operates properly only if the terms are interpreted using the same criteria (see Rev. Rul. 63-6, 1963-1 C.B. 126, 128), and therefore both must be determined under principles of United States tax law.

B. The Court of Appeals' Interpretation Undermines The Statutory Policy Of Providing The Same Relief From Double Taxation For Domestic Companies That Operate Through Foreign Subsidiaries As Is Provided To Those That Operate Through Foreign Branches

1. One of the major concerns that pervades the foreign tax credit provisions is the desire to provide domestic companies, like respondent, that operate their foreign businesses through separately incorporated foreign subsidiaries with the same relief from double taxation that is provided to companies that operate through unincorporated foreign branches. A foreign branch is simply a part of the larger domestic company; it is not a separate taxable entity. Therefore, all of its income earned in a foreign country is automatically income to the larger domestic company and is subject to taxation on its United States income tax return. Since 1918, the domestic company has been entitled to take a credit against its United States income tax for the foreign income taxes paid by its branch. See Revenue Act of 1918, ch. 18, § 238(a), 40 Stat. 1080. This is the "direct" credit that is now contained in Section 901 of the Code.

The "indirect" credit of Section 902 at issue here is necessary to prevent companies that operate through foreign subsidiaries from being placed at a relative disadvantage to their counterparts that operate through foreign branches. The domestic parent of a foreign subsidiary cannot take any direct credit for foreign taxes under Section 901 because it does not pay any foreign tax; rather, the tax is paid by its foreign subsidiary, which is a separate entity for tax purposes. Section 902 allows the domestic parent to take an apportioned credit for those foreign taxes as if it had paid them itself. The apportionment aspect of Section 902 is necessary to prevent companies that operate through foreign subsidiaries from gaining an advantage over their counterparts that operate through foreign branches. When the subsidiary does not distribute all of its earnings to the domestic parent, then allowing the parent a credit for the full amount of the foreign tax paid would overcompensate for the possibility of double taxation and would provide a tax benefit that is not available to companies that operate through foreign branches. Thus, the apportionment formula of Section 902 is designed to limit the allowable indirect credit to the amount of foreign tax that was paid on the earnings actually distributed to the parent. See generally *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 7-10 (1932).

The legislative history of the foreign tax credit provisions demonstrates Congress's fundamental and continued concern that the statute promote equality of treatment of the two forms of conducting business abroad. In connection with the 1921 legislation that introduced the term "accumulated profits" into the ratio for computing the indirect credit, a spokesman for the Treasury explained that an American corporation with a foreign subsidiary is, "economically and practically," in much the same position as a domestic business with a foreign branch and "[t]he proposal is to give this American corporation about the same credit as if conducting a branch" (*Internal Revenue: Hearings on H.R. 8245 before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 389 (1921) (statement of Dr. Adams)). See also *Associated Telephone & Telegraph Co.* v. *United States*, 306 F.2d 824, 832 (2d Cir. 1962), cert. denied, 371 U.S. 950 (1963). Senator Smoot, the sponsor of the legislation, echoed these sentiments on the floor of Congress, explaining

how the mechanism of a prorated credit would operate to achieve parity of tax treatment between the two forms of operating foreign business. See 61 Cong. Rec. 7184 (1921).[12]

Subsequent amendments to the foreign tax credit provisions have also been specifically intended to further the goal of providing the same relief from possible double taxation for both modes of conducting foreign business. In the Revenue Act of 1962, Congress amended Section 902 and added Section 78 of the Code, which requires domestic companies to "gross up" (include in income) the foreign tax paid by the subsidiary (see note 10, *supra*). The purpose of this change was to eliminate a tax advantage enjoyed by a subsidiary operation over a branch operation. See S. Rep. No. 1881, 87th Cong., 2d Sess. 66-67 (1962); see also B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 17.11, at 17-45 to 17-47 (5th ed. 1987) (emphasis deleted) (1962 amendment "attacked * * * preference for the use of foreign subsidiaries" and "equalize[d] the treatment of foreign subsidiaries and unincorporated branches with respect to the foreign tax credit for the distributed earnings of the subsidiary").[13] In the Tax Reform Act of 1986, Congress made additional changes in the indirect credit provisions (see note 17, *infra*); one reason given for some of these changes was the desire "to provide more similar results" for branch and subsidiary operations. See S. Rep. No. 313, 99th Cong., 2d Sess. 306 (1986).

2. The decision of the court of appeals undermines this congressional policy by introducing major disparities in the treatment of companies depending upon whether they operate through subsidiaries or

[12] Senator Smoot explained the purpose of the indirect credit as follows (61 Cong. Rec. 7184 (1921)):

> This amendment extends the credit for foreign income and profits taxes paid, to a domestic corporation which owns a majority of the voting stock of a foreign subsidiary, from which subsidiary the domestic corporation receives taxable dividends.
>
> In such a case a foreign subsidiary is much like a foreign branch of an American corporation. If the American corporation owned a foreign branch, it would include the earnings or profits of such branch in its total income, but it would also be entitled to deduct from the tax based upon such income any income or profits taxes paid to foreign countries by the branch in question. Without special legislation, however, no credit can be obtained where the branch is incorporated under foreign laws.
>
> Since the foreign subsidiary may not send back to the American parent company all of its profits or earnings, it follows that the American parent company should not obtain a credit for all the income and profits taxes paid to foreign countries by the European subsidiary. The amendment in question grants only a partial or prorated credit.

Senator Pomerene, with Senator Smoot's agreement, later summarized the operation of the indirect credit as follows (*ibid.*):

> To put it in another way, certain of its profits could be passed to surplus over there, and if not distributed in dividends, then the parent company would not receive credit for that part which went to surplus.

[13] Under pre-1962 law, the dividend income recognized by a parent would never exceed the foreign subsidiary's *after-tax* income, while a domestic corporation operating through a branch would recognize the branch's *pre-tax* foreign income. While this advantage for subsidiaries was reduced by the *American Chicle* limitation on the indirect credit (see pp. 22-24 & note 10, *supra*), it was not completely eliminated. See S. Rep. No. 1881, *supra*, at 66-67; B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-45 to 17-47.

branches. Foreign concepts of taxable income play no role in determining whether the earnings of a foreign branch constitute income in the hands of the domestic owner; those earnings flow directly to the owner and are recognized according to United States tax principles. As noted by Senator Smoot in explaining the 1921 amendment on the floor of the Senate (see note 12, *supra*), "[i]f the American corporation owned a foreign branch, it would include the earnings or profits of such branch in its total income" (61 Cong. Rec. 7184 (1921)). If the apportionment formula is to serve its purpose of avoiding disparities between the two kinds of business arrangements when a subsidiary distributes only a portion of its earnings, the "accumulated profits" of a foreign subsidiary must approximate the taxable income that would be recognized by the parent if it were operating as a branch. Otherwise, a distribution of all of the subsidiary's earnings and profits, which is equivalent to what always occurs in a branch operation, will not yield the same tax treatment for both forms of business. By the same token, unless the point of reference for the apportionment, *i.e.*, the total pool of earnings that potentially could be distributed by the subsidiary, is correlated with the income that would be recognized if the business were organized as a branch, the fractional credit computed under Section 902 will not apportion the credit so as to provide the same relief from double taxation to companies that operate through foreign branches and those that operate through subsidiaries. This means that the "accumulated earnings" must be computed under United States law, just like the income received by the domestic owner of a foreign branch.

The necessity for accumulated profits to be based upon principles of United States law may be illustrated by the basic example provided earlier (p. 22, *supra*), where the foreign entity pays $20 in foreign tax on profits computed at $100 under United States law and $180 under foreign law. A foreign branch would be treated as having funneled all of its profits (which would be $100 under United States law) to the domestic company, and it would receive the full $20 "direct" credit under Section 901. If the same business were conducted by a foreign subsidiary, however, and the subsidiary distributed all of its $80 in after-tax profits to the parent, computation of accumulated profits under foreign law would limit the parent to a credit for only half of the foreign taxes paid ($20 x $80/($180 - $20) = $10). This result is clearly incorrect under the statute because a domestic parent that receives a dividend distribution of all of the subsidiary's earnings should receive the same credit as if it operated its foreign business through a branch. Computing the accumulated profits of the subsidiary under United States law, conversely, would yield the correct result of the same credit available to the branch ($20 x $80/($100 - $20) = $20).

In this example, the foreign measure of income is higher than that of the United States, and therefore the result under the court of appeals' approach is to understate the credit to the disadvantage of the company operating through a subsidiary. If, as in the present case, the foreign definition of income yields a figure lower than that computed under United States law, the allowable credit under the court's approach will correspondingly be greater, thereby conferring a comparative advantage on the company

that operates through a subsidiary. In both cases, however, the court of appeals' approach subverts the clearly expressed legislative policy to avoid discrimination between the two methods of doing business abroad.

In sum, like the direct credit granted to a domestic company with a foreign branch, the indirect credit of Section 902 treats the amount of foreign tax paid as a fact. It is not concerned with how the foreign tax is computed or with the foreign income base on which the tax is imposed. It simply takes the amount of foreign tax paid and apportions it in accordance with the fractional share of the subsidiary's "accumulated profits" that is actually distributed as a dividend. To make the credit work properly, and to ensure parity of treatment with companies that operate through a foreign branch, the term "accumulated profits" in Section 902 must refer to the pool of earnings available for distribution as income to the parent—*i.e.*, earnings computed under principles of United States taxation.

C. The Court of Appeals' Decision Erroneously Overturns The Longstanding Administrative And Judicial Construction Of Section 902

1. For more than 50 years, the Treasury has uniformly interpreted the term "accumulated profits" in Section 902 and its predecessors to mean income or profits as defined under principles of United States taxation. In 1933, the Commissioner declared that "the amount of the accumulated profits" is "based as a fundamental principle upon all income of the foreign corporation available for distribution to its shareholders, *whether such profits be taxable by the foreign country or not.*" I.T. 2676, XII-1 C. B.

48, 50 (1933) (emphasis added). Accordingly, he ruled that deductions and credits allowed by foreign countries as offsets to taxable income, but not allowed as deductions under United States tax laws, do not reduce accumulated profits for purposes of the Section 902 credit because they "in no way reduce distributable income or surplus" (*id.* at 51). The inventory adjustments and accelerated depreciation that respondent's subsidiary claimed under British law fall squarely within the category of special deductions not permitted under United States law that, according to the ruling, do not decrease accumulated profits. The position of the Treasury in this case is therefore identical to the one it announced in 1933.

Since the publication of the 1933 ruling, the Treasury has consistently followed the principle that "accumulated profits" are determined by United States law. This position was embodied in a formal regulation in 1965, Treas. Reg. § 1.902-3(c)(1) (1965) (now codified at Treas. Reg. § 1.902-1(e)), which defined the accumulated profits of a foreign subsidiary for a taxable year as "the sum of (i) the *earnings and profits* of such corporation for such year, and (ii) the foreign income taxes imposed on or with respect to the gains, profits and income to which such earnings and profits are attributable" (emphasis added). "Earnings and profits" is an established term that represents the source of payments treated as dividends under Section 316 of the Code, and there is no doubt that its calculation depends upon the rules for determining United States taxable income. See pp. 18-19, *supra*; I.R.C. § 312; B. Bittker & J. Eustice, *supra*, ¶ 7.03. In Rev. Rul. 63-6, 1963-1 C.B. 126, 128, the Commissioner explained the rationale for basing the calculation of "accumulated

profits" under Section 902 upon the concept of "earnings and profits" as defined by Section 316—namely, that the term "dividends" has the same meaning in both sections and "both 'accumulated profits' and 'earnings and profits' denote the same source from which 'dividends' are paid." The Commissioner has consistently adhered to this position. See Rev. Rul. 74-310, 1974-2 C.B. 205; Rev. Rul. 87-14, 1987-1 C.B. 181; Rev. Rul. 87-72, 1987-2 C.B. 170.[14]

This Court has repeatedly held that interpretive rules and regulations promulgated by the Commissioner, "if found to 'implement the congressional

[14] There is no merit to respondent's assertion (Br. in Opp. 11) that the Treasury abandoned its position that "accumulated profits" are identified with "earnings and profits" when it declared Rev. Rul. 63-6 to be "obsolete" in Rev. Rul. 72-621, 1972-2 C.B. 651. The 1963 ruling was never revoked. It is common for a ruling to be classified as "obsolete" (*i.e.*, not controlling for future transactions) when it has become "unnecessary because the issue has been covered by regulations" (Rev. Rul. 67-6, 1967-1 C.B. 576, 577). That is precisely what occurred here. Rev. Rul. 63-6 construed Section 902 as it read before amendment by the Revenue Act of 1962. Subsequent to that statutory change, the Treasury promulgated the formal regulation described above, Treas. Reg. § 1.902-3(c)(1) (1965), interpreting the amended statute. Because that regulation embodied the substance of Rev. Rul. 63-6 and construed the new version of the statute, the ruling was declared "obsolete" under the criteria developed by the Treasury for reducing the number of outstanding rulings. Rev. Rul. 63-6 and the regulation continue to be recognized as setting forth the Treasury's position that "accumulated profits" are computed in accordance with the principles governing the calculation of earnings and profits under United States law. See S. Rep. No. 313, *supra*, at 299 n.6; *Champion International Corp.* v. *Commissioner*, 81 T.C. 424, 433 (1983); *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. at 78-79.

mandate in some reasonable manner,' must be upheld." *National Muffler Dealers Assn.* v. *United States*, 440 U.S. 472, 476 (1979) (quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973)); see also, *e.g.*, *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Commissioner* v. *Wheeler*, 324 U.S. 542, 546 (1945). Regulations carry particular force if they have been consistently followed by the Commissioner for many years, so long as they are harmonious with the governing statute. See 440 U.S. at 477; *United States* v. *Correll*, 389 U.S. 299, 305-306 (1967) (quoting *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938)) ("Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."). Here, the regulation defining accumulated profits with reference to United States concepts of taxation reflects a position first announced by the Treasury more than 55 years ago and adhered to consistently ever since. Moreover, as the Claims Court correctly stated, "[t]he regulation is consistent with the purposes enunciated by Congress when enacting the indirect tax credit legislation" (Pet. App. 26a). Accordingly, the Treasury's longstanding interpretation of "accumulated profits" in Section 902 is entitled to substantial deference.

2. Although this established administrative position has, for the most part, not been challenged in litigation, it has been approved by the Tax Court on two occasions. *Steel Improvement & Forge Co.* v. *Commissioner*, 36 T.C. 265, 276-282 (1961), rev'd on other grounds, 314 F. 2d 96 (6th Cir. 1963), is directly in point. There, a domestic corporation re-

ceived dividends from a foreign subsidiary in 1953 and 1954 that were covered by the subsidiary's accumulated profits for the years of the distributions. The subsidiary reported a loss on its foreign tax return for a later year, however, and it carried back the loss to reduce its income for 1953 and 1954, thereby generating a refund of all the foreign tax paid for those years. For purposes of computing the parent's indirect foreign tax credit, the Commissioner recognized the refund and treated the subsidiary as having paid no creditable foreign tax in 1953 and 1954 (see I.R.C. § 905(c)). Because the loss and carryback were allowable only under the tax law of the foreign country, however, the Commissioner did not decrease the subsidiary's "accumulated profits," reasoning that they must be computed under principles of United States taxation. Thus, he continued to treat the dividends as covered by the accumulated profits of the years in which they were distributed, and, because no creditable foreign tax was paid for those years, he did not allow any foreign tax credit on the taxpayer's United States income tax returns for 1953 and 1954. The Tax Court upheld the Commissioner's position in a reviewed decision, stating that "the accumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law" (36 T.C. at 277).

The Tax Court reaffirmed this holding in *Champion International Corp.* v. *Commissioner*, 81 T.C. 424 (1983). The foreign subsidiary in that case, unlike the subsidiary in *Steel Improvement* and respondent's subsidiary, sustained a loss that could be carried back under both United States law and the tax law of the foreign country. The question in the case was the

year in which the loss should be recognized for purposes of computing "accumulated profits." In permitting the carryback sought by the taxpayer, the Tax Court noted that "[t]he accumulated profits in the denominator [of the Section 902 fraction] represent the fund from which the dividends were paid and must be determined in accordance with U.S. law" (81 T.C. at 433; see also *id.* at 431). The court discussed *Steel Improvement* at length and specifically approved its holding (*id.* at 446-447), stating unequivocally that "[a]ccumulated profits are determined under American law rather than foreign law" (*id.* at 447).[15]

[15] Contrary to the court of appeals' assertion (Pet. App. 7a-8a), the Tax Court in *Champion* did not misconstrue its own decision in *Steel Improvement*. In *Steel Improvement* the Tax Court ruled that "the accumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law" (36 T.C. at 277), and it supported that ruling by reference to decisions involving the computation of earnings and profits under Section 316. The only question before the Tax Court in *Steel Improvement* was whether a loss recognized only by a foreign jurisdiction could be carried back to reduce "accumulated profits" for purposes of the Section 902 credit; therefore, the court of appeals' suggestion that the Tax Court was not interpreting Section 902 is mistaken. Rather, the Tax Court's statement in *Steel Improvement* can reasonably be understood to mean only that "accumulated profits," like earnings and profits, are determined under United States law. See Pet. App. 17a-19a. The Tax Court recognized this fact in *Champion*, as did Congress when it cited *Steel Improvement* as standing for this proposition in a committee report concerning the 1986 amendments to Section 902. See S. Rep. No. 313, *supra*, at 299 & n.6.

The court of appeals' reliance (Pet. App. 7a) on the Tax Court's criticism in *Champion* of *Pacific Gamble Robinson Co.* v. *United States*, 62-1 U.S.T.C. (CCH) ¶ 9160 (W.D.

Numerous texts and commentaries on the foreign tax credit likewise have concluded that accumulated profits must be computed under principles of United States taxation.[16] And Congress, in the course of amending the foreign tax credit provisions in other respects in 1986, explicitly noted its recognition that, under existing law, "accumulated profits * * * are generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes" (S. Rep. No. 313, *supra*, at 299). The Senate Report cited *Steel Improve-*

Wash. Dec. 15, 1961), is equally unfounded. *Pacific Gamble* involved the same issue as *Champion*—whether a loss sustained by the foreign subsidiary that is recognized under the tax law of both the United States and the foreign country can be carried back to reduce the "accumulated profits" of an earlier year. The district court in *Pacific Gamble* denied the carryback; the Tax Court in *Champion* criticized that holding and reached the opposite conclusion (see 81 T.C. at 443 n.29). Neither of these holdings has any bearing on the issue presented here, which concerns the treatment of the 1973 loss that is allowed only by foreign law. Hence, both *Pacific Gamble* and *Champion* are fully consistent with the Commissioner's position here.

[16] See 1 E. Owens & G. Ball, *The Indirect Credit* 161-162 (1975); E. Owens, *The Foreign Tax Credit* 119-121 (1961); B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-44 to 17-45; *Federal Income Tax Project: International Aspects of United States Income Taxation* 398 (A.L.I. 1987); Schoenfeld, *Some Definitional Problems in the Deemed Paid Foreign Tax Credit of Section 902: "Dividends" and "Accumulated Profits,"* 18 Tax L. Rev. 401, 407-421 (1963); Eigner, *The Foreign Tax Credit*, 39 Taxes 724, 729-730, 736 (1961); Mentz, *The Effect of Net Operating Losses on the Foreign Tax Credit*, 30 Tax Law. 309, 324 n.36, 333 (1977); Burda, *The Foreign Loss Carryback Dilemma: Gone But Not Forgotten*, 13 Int'l Tax J. 199, 206 (1987).

ment, Treas. Reg. § 1.902-1(e), and Rev. Rul. 63-6, *supra*, as evidencing this settled proposition (S. Rep. No. 313, *supra*, at 299 n.6).[17] See also H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 841 (1984) (for purposes of the "deemed paid" credit, "accumulated profits are essentially equivalent to earnings and profits"). Thus, the decision below clearly departs from "the generally accepted view that (E & P) and accumulated profits are computed in accordance with U.S. concepts * * *." Fuller, *Section 902 Accumulated Profits: The Federal Circuit*

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[17] The 1986 Act prospectively changed the operation of the Section 902 credit to eliminate the "annualization" approach, *i.e.*, the matching of the dividend to accumulated profits on a year-by-year basis (see note 4, *supra*). See Section 1202(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2528. Because Congress believed that this scheme was subject to manipulation by taxpayers and also subject to other problems, it provided that retained earnings after 1986 would all go into one "pool," which would be the source of the dividends. See generally S. Rep. No. 313, *supra*, at 305-306; B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-47 to 17-48. Congress accomplished this change by redrafting Section 902, including replacing the term "accumulated profits" with the term "post-1986 undistributed earnings." The latter term is defined as the "earnings and profits" of the foreign subsidiary accumulated in years after 1986 and computed "according to rules substantially similar to those applicable to domestic corporations" (see 26 U.S.C. 902(c)(1) (Supp. IV 1986) and 964(a)). Therefore, while Congress was not focusing on the question presented here in drafting the 1986 legislation, it is nonetheless clear that, under the new law, United States tax principles must be used in defining the subsidiary's profits to be used in the apportionment formula of Section 902. Congress manifestly believed that it was perpetuating existing law on this issue. See S. Rep. No. 313, *supra*, at 299 & n.6.

Takes a Different View in Goodyear, 17 Tax Mgmt. Int'l J. (BNA) 502, 503 (1988).

3. This established interpretation of "accumulated profits" also accords with the general principle concerning the construction of the foreign tax credit provisions that was laid down by this Court in *Biddle v. Commissioner*, 302 U.S. 573 (1938). The Court there stated that, because the subject matter of the Code is the computation of United States income tax, it should be presumed that Congress intended that "its own criteria" would be used to interpret the terms of the statute (*id.* at 578). The Court explained that this presumption could be rebutted only if "the statute, by express language or necessary implication, makes the meaning of the phrase * * * depend upon its characterization by the foreign statutes" (*ibid.*). Under this principle, the Court in *Biddle* held that the phrase "income taxes paid or accrued" in a predecessor to Section 901(b)(1) was to be interpreted in accordance with United States tax law, finding "nothing in [the statute's] language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation" (*id.* at 578-579).

There is similarly nothing in Section 902 to suggest that the computation of accumulated profits for purposes of the indirect credit should be made under the laws of a foreign country rather than under the laws of the United States. Under the heretofore settled rule, the prorated credit is computed solely by reference to the familiar principles of the Internal Revenue Code; the vagaries of foreign tax law play no role. The court of appeals' approach, however, would require that the court determine the taxpayer's

accumulated profits under the unfamiliar tax principles of various foreign jurisdictions, which may be difficult to ascertain and may contain concepts of profits and taxable income that are profoundly different from those of the United States. This imposition of a "shifting standard * * * adopted by reference to foreign characterizations and classifications of tax legislation" (302 U.S. at 578-579) would depart from the teaching of *Biddle* and would create troublesome and unwarranted interference with the proper administration of the statute.[18]

D. The Court Of Appeals' Interpretation Is Not Supported By Either The Plain Meaning Of The Statute Or Its Policy Of Preventing Double Taxation

1. The court of appeals relied almost entirely on what it found to be the "plain meaning" of Section

[18] It is doubtful whether there is any foreign country whose income tax laws accord with those of the United States in every respect. Thus, the court of appeals' approach could seriously burden the fair administration of the Section 902 credit no matter where a foreign subsidiary of a domestic corporation does business. Those problems could be compounded if a subsidiary earns income in, and pays taxes to, more than one foreign jurisdiction, requiring a revenue agent to be conversant with the idiosyncrasies of each system in order to identify the profits out of which a dividend is declared. In the present case, the parties stipulated to the computation of taxable income under British law, and respondent did not contend that the revenue laws of Ireland, where its subsidiary also did business (see Pet. App. 10a), differed in material respects from the tax laws of the United States. There is no assurance that the parties would agree on the vagaries of foreign law in other cases; the court of appeals' decision thus could lead to burdensome litigation over the precise contours of income, deductions, or losses under differing schemes of taxation.

902 (Pet. App. 6a), without even acknowledging the longstanding contrary administrative construction that had been approved by the Tax Court and relied upon by the Claims Court below. Its holding rests on one phrase in Section 902 read in isolation. Because the statute refers to foreign taxes paid "on or with respect to * * * accumulated profits" (§ 902 (a)(1); see also § 902(c)(1)), the court held that "accumulated profits" must be defined as the "actual basis on which the foreign sovereign assesses tax liability," *i.e.*, taxable income as computed under foreign law (Pet. App. 6a). But this reasoning, which in any event hardly represents a "plain meaning" construction, loses any semblance of force when the entire statute is examined.

The prefatory clause of Section 902(a)(1) refers to the "dividends * * * paid by such foreign corporation out of accumulated profits." Under the court of appeals' own reasoning, this language indicates that the statutory "relationship" that must not be "sever[ed]" (see Pet. App. 6a) is the one between the dividends received by the parent (and subjected to United States income taxation) and the accumulated profits out of which the dividends are paid. As we have seen (pp. 18-19, *supra*), the Code specifies that payments are treated as "dividends" to the extent that their source is "earnings and profits." Hence, this clause of Section 902 essentially identifies "accumulated profits" with "earnings and profits." Even the court of appeals recognized "the undisputed and well-settled fact that 'the determination of a foreign corporation's *earnings and profits* * * *, for purposes of the imposition of the U.S. tax, is to be made by the application of U.S. tax principles'" (Pet. App. 7a (quoting *H.H. Robertson Co. v. Commissioner*,

supra, 59 T.C. at 69)). Thus, the court of appeals' approach to parsing the statute is indeterminate; depending upon which clause of Section 902(a)(1) is examined, it points to the conclusion that "accumulated profits" are computed under United States law at least as strongly as it suggests that foreign law principles should be used.

Moreover, even if one focuses narrowly on the "taxes paid" clause on which the court of appeals relied, there is little support in the text of the statute for the court of appeals' conclusion. This is precisely the phrase that this Court construed in *American Chicle Co.* v. *United States*, *supra*. As we have explained (see pp. 22-25, *supra*), the teaching of that case is that this clause—the "taxes paid * * * on or with respect to the accumulated profits"—limits the allowable credit to the foreign tax attributable to the earnings of the subsidiary that are available for distribution as dividends in the United States. The maximum amount of the subsidiary's earnings available for distribution as a dividend depends upon the subsidiary's "earnings and profits," a figure determined under United States law. Thus, even the "taxes paid" clause, when construed in light of *American Chicle*, supports the Commissioner's position that accumulated profits are calculated under United States law.[19]

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[19] The court of appeals' reliance (Pet. App 6a) on Rev. Rul. 74-310, 1974-2 C.B. 205, is misplaced. That ruling provides no support for the court's theory that the term "accumulated profits" in the "taxes paid" clause means the foreign tax base to which the foreign government actually applies its tax. Indeed, in holding that the foreign income tax paid for a given year is deemed to have been paid "on or with respect to" that year's accumulated profits as computed under United States principles even though the profits are computed dif-

It is therefore apparent that the "plain meaning" of the statute does not provide an adequate basis for the court of appeals' decision. Indeed, if any "plain meaning" can be gleaned from examination of the statute alone, it is the meaning suggested by the general principle of *Biddle* v. *Commissioner, supra*—namely, that provisions of the Internal Revenue Code governing the computation of domestic income taxes are to be interpreted in accordance with United States law in the absence of some express indication to the contrary. The correct meaning of "accumulated profits" must be derived from its context in Section 902, taking into account the purposes of the statute and the way in which the credit is designed to work. That inquiry, as we have shown, clearly demonstrates that the amount of "accumulated profits" is to be determined in accordance with United States tax law.

2. The court of appeals' belief that its interpretation would promote the statutory goal of preventing double taxation (Pet. App. 6a-7a) is similarly unfounded. The court's analysis rested in large part on assuming the answer to the question presented; once it had concluded that the credit is correctly computed by determining "accumulated profits" under foreign law, the court reasoned that the higher amount of tax that respondent would owe if United States law principles are used (see pp. 6-7 & note 5, *supra*) must reflect double taxation. The court summarized its analysis by stating that "the IRS view inflates" the

ferently under the tax law of the foreign country, the ruling implicitly rejects the theory of the court of appeals below. See 1 E. Owens & G. Ball, *The Indirect Credit* 82 (1975). Moreover, the ruling specifically incorporates the definition of accumulated profits in Treas. Reg. § 1.902-3(c)(1), which identifies accumulated profits with "earnings and profits" as determined under United States law.

amount of accumulated profits, which would yield "double taxation" because "tax payments already made to the foreign country will not be fully recoverable as tax credits" (*id.* at 6a-7a).

The court of appeals' analysis is misguided. When accumulated profits are determined under United States tax principles, the foreign taxes paid by a subsidiary in a given year remain "fully recoverable" when the profits for that year are fully distributed to the parent. That respondent's correctly computed indirect tax credit on its 1970 and 1971 tax returns is smaller than the credit that would be computed by defining accumulated profits under foreign law principles is not the result of double taxation, but rather is the necessary and appropriate consequence of the favorable tax treatment allowed to respondent's subsidiary by British law. Because British law permitted a loss and carryback to 1970 and 1971 not available under United States law, the subsidiary's profits for those years when computed under United States law were much higher than under British law, *and the subsidiary paid no tax to Britain on those additional United States profits.* Those profits computed under United States law were sufficient to cover the dividends that the subsidiary distributed in 1970 and 1971, and the Commissioner accordingly "sourced" the dividends to those profits for purposes of computing the Section 902 credit. See Pet. App. 23a-24a. Since the subsidiary paid no foreign tax on the additional "United States profits," there was no danger that those profits would be subject to double taxation when distributed as dividends includable in respondent's United States income. Rather, those profits were taxed *for the first time* as income by the United States.

Under the statutory scheme, therefore, respondent is simply not entitled to any foreign tax credit with respect to those additional United States profits—a manifestly reasonable result since its subsidiary had paid no foreign tax upon them. By contrast, respondent's position would distort the credit by treating the dividends in question as a distribution of profits earned in prior years (1968 and 1969) when the subsidiary paid higher taxes to Britain. Obviously, respondent would secure a tax advantage if it could treat the dividend as coming entirely from profits that had previously been subject to foreign tax (thus necessitating a credit on the United States return in order to avoid double taxation). Nothing in Section 902, however, entitles respondent to overlook the earnings and profits of 1970 and 1971 that were not subjected to foreign taxation. Under the governing rules of Sections 312 and 316 of the Code, the dividends received by respondent were paid out of the subsidiary's 1970 and 1971 profits; the 1968 and 1969 profits were not distributed to respondent. Thus, respondent seeks a credit for foreign taxes paid with respect to undistributed profits. Because the basic function of the statute's apportioning fraction is to grant a credit only for profits distributed as dividends to the United States parent, not for profits retained by the foreign subsidiary as surplus, the Claims Court correctly described respondent's position as seeking "a substantial windfall" that would "eviscerate the very purpose of the pro-rata credit" (Pet. App. 24a).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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JULY 1989

APPENDIX

The Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the years 1970 and 1971, provided in pertinent part:

§ 316. **Dividend defined.**

(a) **General rule.**

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

§ 901. **Taxes of foreign countries and of possessions of United States.**

(a) **Allowance of credit.**

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the applicable limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this

chapter for such taxable year. The credit shall not be allowed against the tax imposed by section 56 (relating to minimum tax for tax preferences), against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1333 (relating to war loss recoveries) or under section 1351 (relating to recoveries of foreign expropriation losses), or against the personal holding company tax imposed by section 541.

(b) **Amount allowed.**

Subject to the applicable limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) **Citizens and domestic corporations.**

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profit taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; * * *

§ 902. **Credit for corporate stockholder in foreign corporation.**

(a) **Treatment of taxes paid by foreign corporation.**

For the purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall—

(1) to the extent such dividends are paid by such foreign corporation out of accumulated profits (as defined in subsection (c)(1)(A)) of a

year for which such foreign corporation is not a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States on or with respect to such accumulated profits, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid); * * *

* * * * *

(c) **Applicable rules.**

(1) **Accumulated profits defined.**

For purposes of this section, the term "accumulated profits" means with respect to any foreign corporation—

(A) for purposes of subsections (a)(1), (b)(1)(A), and (b)(2)(A), the amount of its gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country or any possession of the United States; and

* * * * *

The Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (un-

less to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

The Treasury Regulations on Income Tax (26 C.F.R.), as in effect in 1970 and 1971, provided in pertinent part:

§ 1.902-3 **Credit for domestic corporate shareholder of a foreign corporation** (after amendment by Revenue Act of 1962).

* * * * *

(c) **Determination of accumulated profits and taxes paid on or with respect thereto**—(1) First-tier corporation which is not a less developed country corporation. The accumulated profits for any taxable year of a first-tier corporation which is not a less developed country corporation, as defined in § 1.902-4, for such year shall in accordance with section 902 (c) (1) (A), be the sum of—

(i) The earnings and profits of such corporation for such year, and

(ii) The foreign income taxes imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable.

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QUESTION PRESENTED FOR REVIEW

In computing the credit under section 902 of the Internal Revenue Code[1] for foreign taxes deemed paid by a domestic corporation with respect to dividends received from its foreign subsidiary, should the accumulated profits of the foreign subsidiary be allocated to various years, for purposes of determining the source of dividends paid, (a) as determined by the foreign government in imposing its tax or (b) in accordance with the rules that would have been applied by the United States in determining the taxable income of a domestic corporation?

The Goodyear Tire & Rubber Company, the Respondent here, has restated the question to make it plain that the question presented involves associating the profit which is the source of the dividend with the foreign tax imposed on that profit for which the credit is claimed. The question presented as stated by the Government in its brief is ambiguous in this regard and does not clearly reflect the issue defined by the Stipulation of Facts and decided by the Court of Appeals.

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[1]Unless otherwise noted, citations to the Internal Revenue Code and "section" references herein are to the Internal Revenue Code of 1954 as in effect in 1970 and 1971 or to the sections thereof, as the case may be.

RULE 28.1 LIST OF AFFILIATES

The Rule 28.1 List of Affiliates previously submitted by The Goodyear Tire & Rubber Company and Affiliates on pages (ii) and (iii) of its Brief in Opposition to the Petition for a Writ of Certiorari in this case currently is accurate.

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TABLE OF AUTHORITIES

No. 88-1474

IN THE

Supreme Court of the United States

October Term, 1988

UNITED STATES OF AMERICA, *Petitioner*,

v.

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, *Respondent*.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE RESPONDENT

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves sections 901 and 902 of the Internal Revenue Code of 1954 (26 U.S.C. §§ 901 and 902) and section 1.902-3(c)(1) and (4) of the Treasury Regulations (26 C.F.R. § 1.902-3(c)(1) and (4)), as in effect for 1970 and 1971. Section 1.902-3(c)(4) of the Treasury Regulations is set forth below in pertinent part in an appendix to this brief. Resp. App., *infra* pp. A1-A2. Sections 901 and 902 of the Internal Revenue Code of 1954 and Section 1.902-3(c)(1) of the Treasury Regulations are set forth in pertinent part in the Appendix to Petitioner's Brief. Pet. App. at 1a-4a.

STATEMENT OF THE CASE

1. **Procedural.** In its federal income tax returns for 1970 and 1971, the Respondent, The Goodyear Tire & Rubber Company and Affiliates ("Goodyear"), claimed foreign tax credits for taxes deemed paid with respect to dividends received from its wholly-owned British subsidiary, The Goodyear Tyre & Rubber Company (Great Britain) Limited ("Goodyear England"). The Petitioner, The United States of America (the "Government"), disallowed the credits claimed, assessing additional taxes and interest for those years.

Goodyear paid the assessments and filed claims for refund. When the refunds were denied, Goodyear sued in the United States Claims Court. *Goodyear Tire & Rubber Company and Affiliates v. United States of America,* No. 510-85 T. Goodyear and the Government submitted cross motions for summary judgment in the Claims Court proceeding (Joint Appendix filed with the Federal Circuit at 32, 36) and the Claims Court granted the Government's motion and denied Goodyear's motion. 14 Cl. Ct. 23; Cert. App. at 9a-28a.[2] On appeal by Goodyear, the United States Court of Appeals for the Federal Circuit unanimously reversed the Claims Court. 856 F.2d 170; Cert. App. at 1a-8a, 29a.

Thereafter the Court of Appeals unanimously denied the Government's motion for rehearing, and the entire Court of Appeals, with one dissent, declined the Government's suggestion for rehearing *en banc.* Cert. App. at 30a-31a. This Court granted a writ of certiorari to the Court of Appeals on May 1, 1989. J.A. at 62.

2. **Substantive.** The relevant facts and the issue in this case have been stipulated (J.A. 19-29) or appear in an affidavit filed with Goodyear's Motion for Summary Judgment. Joint Appendix filed with the Federal Circuit at 34-35.

[2] "Cert. App." refers to the Appendices to the Petition for a Writ of Certiorari; "J.A." refers to the Joint Appendix filed with this Court; "Pet. App." refers to the appendix to the Government's Brief on the Merits; and "Resp. App." refers to the appendix to this brief.

In each year of the years 1968 through 1971, Goodyear England had substantial income (before net operating loss carryback deductions) and paid dividends to Goodyear. A small part of its income was derived from Ireland and the rest from its operations in Great Britain. Stip. ¶ 6, J.A. at 11; Ex. M-P, J.A. at 32-49; Stip. ¶ 16, J.A. at 25.

In 1972 and 1973 Goodyear England incurred losses. Stip. ¶ 6, J.A. at 21. The losses were generated, in principal part, by the application of two provisions of British tax law that differ from U.S. law. First, with respect to purchases of new fixed assets during the year, the British depreciation provisions allowed shorter useful lives in 1971 and thereafter than would have been allowed by U.S. law to a U.S. taxpayer. Stip. ¶ 10, Ex. B and C, Joint Appendix filed with the Federal Circuit at 43, 56-58, 60-61. Second, in computing the 1973 closing inventory, British law permitted a British taxpayer to reduce its inventory by the increase in the inventory's value less 10% of "trading profit" for the year. Stip. ¶ 9, Ex. A, Joint Appendix filed with the Federal Circuit at 42-43, 51-55.

The treatment of the 1973 loss and the adjustments to Goodyear England's 1970, 1971, and 1973 income as a result of the loss and its carryback gave rise to the present case.[3] The 1973 loss (as determined to the satisfaction of the British tax authorities) was applied by

[3] There is no dispute as to the amount of the 1972 loss. That loss, computed in accordance with the British tax law, was carried back to 1971 and applied to reduce Goodyear England's accumulated profits for 1971. The 1972 loss also reduced the British taxes paid for 1971 because the amount of the 1972 loss was known by the time the 1971 tax was paid. The 1971 dividend was thus previously considered to have been paid out of the accumulated profits for 1971 as reduced by the 1972 loss carryback and by the net taxes paid. The Commissioner of Internal Revenue raised no issue as to the existence or effect of the 1972 loss, and the figures shown in Exhibits I and J to the Stipulation (J.A. at 30-31), which reflect deduction of the 197 net operating loss carryback, are not in dispute.

Goodyear England (pursuant to British law) as a net operating loss carryback deduction first to 1971, where its deduction more than eliminated all remaining 1971 profit of that company. The remainder of the 1973 loss was carried back, again pursuant to British law, to 1970, where its deduction eliminated a large part of Goodyear's profit for that year. Stip. ¶ 14, J.A. at 24. The elimination of Goodyear England's 1971 profit and the reduction of its 1970 profit resulted in the refund to Goodyear England in 1975 of an amount equal to all of its 1971 British tax and a portion of its 1970 British tax. Stip. ¶ 19, J.A. at 26.

Under section 902 of the Code, Goodyear was entitled to a credit for foreign taxes "deemed paid" by it with respect to the dividends it received from Goodyear England. In effect section 902 provides that the tax "deemed paid" by the domestic parent is the tax imposed by the foreign country on the profits of the foreign subsidiary *out of which* the dividend was paid. Goodyear contended that "accumulated profits" refers to the British tax base, as determined by the British taxing authorities, so that, after taking into account the net operating loss carrybacks from 1972 and 1973, the 1970 and 1971 dividends were paid out of accumulated profits for 1968, 1969 and 1970, as set out in Exhibit I (J.A. at 30), and claimed credit for British taxes paid in these years. Stip ¶ 18, J.A. at 26.

The Government contended that "accumulated profits" meant taxable income computed as if Goodyear England had been a U.S. corporation and denied the existence of the 1973 loss and its carryback.

The parties have stipulated that if Goodyear's contention is correct, the redetermination of the foreign tax credits with respect to the dividends paid in 1970 and 1971 is to be made as set out in Exhibit I to the Stipulation (J.A. at 30), while if the Government's contention is correct, the redetermination is to be made as set out in Exhibit J to the Stipulation. J.A. at 31.

NEW POSITION BEING TAKEN BY THE GOVERNMENT FOR THE FIRST TIME IN THIS COURT

A. The Government, in contending that "accumulated profits" means "earnings and profits," has departed from the Stipulation of Facts in this case.

The Stipulation provides in paragraph 7 that:

> . . . the Commissioner determined that the *income before taxes* of Goodyear England computed under United States *income tax* concepts was as follows for the years indicated [reciting the figures used in Joint Exhibit J]. [Emphasis supplied]

Paragraph 24 of the Stipulation provides that:

> Defendant's position with respect to the computation of plaintiff's foreign tax deemed paid relating to the dividends received from Goodyear England for the years 1970 and 1971 as determined under United States tax concepts is set forth in Joint Exhibit J.

Paragraphs 6 and 23 correspondingly specify that Goodyear's position is set out in Joint Exhibit I and is based on the income of Goodyear England "as accepted by the British taxing authorities."

The issue was thus drawn by the Stipulation. The Government now appears to be trying to shift the case to an entirely new issue by claiming that the profits are to be determined on the basis neither of the amounts set forth in Exhibit I as Goodyear contends, nor in Exhibit J as the Government has always heretofore contended, but of what the Commissioner of Internal Revenue might determine to be the "earnings and profits" of Goodyear England, which are not even mentioned in the Stipulation.

Surely the Government cannot now take a position in this Court on which no evidence is presented in the record and that is contrary to the Stipulation on which the case was tried and decided in the Courts below. *See, e.g., General Utilities & Operating Co. v. Helvering*, 296

U.S. 200 (1935); *New York, Lake Erie & W. R.R. Co. v. Estill*, 147 U.S. 591 (1893).

B. By contending that the formula for determining the foreign tax deemed paid is to be applied to the aggregate of past taxes and past income of Goodyear England, the Government is taking a new position which, if correct, must necessarily result in the allowance of most of Goodyear's refund claim.

Another new and surprising element in the Government's brief is the assumption that "accumulated profits" as the phrase is used in section 902 is used in an aggregate sense, including the profits of past years. On page 13 of the Government's brief we find the statement that "accumulated profits" is to be identified with "the pool of potential dividends determined under U.S. law." On page 16 "accumulated profits" is identified as "an ordinary accounting term that includes earnings of prior years as well as current earnings." Similar statements appear elsewhere in the Government's brief on pages 10, 11, 12, 13, 14, 16, 17, 18, and 20. While some reference is made to "sourcing" it does not appear to change the Government's position that "accumulated profits" means aggregate profits for all years.

The taxes, too, are taken by the Government's brief to be on an aggregate basis. Thus in referring to the Revenue Act of 1921 on page 16 of its brief the Government said that Congress "needed to describe the total earnings of the foreign corporation, past and current, which are the source from which dividends can be declared, and then to allow a credit for the *foreign taxes already paid* upon the distributed portion of those earnings." [Emphasis supplied.] Again on page 17 the statutory formula is paraphrased to say in effect that the credit is the proportion of the "foreign taxes paid upon the pool of profits." The same ratio is repeated on pages 19 and 20.

The formula that the Government now asserts actually is the formula of section 902 *as amended prospectively by the Tax Reform Act of 1986*. Pub. L. No. 99-514, § 1202(a), 100 Stat. 2528. If the Act of 1986 applied here there probably would be no issue large enough to litigate. The aggregate of past taxes includes the very taxes (for 1968 through 1970) which Goodyear claims as credits here.

Unfortunately this formula is not the formula that the Internal Revenue Service applied to Goodyear, and in fact a similar formula was rejected by the Tax Court 45 years ago. *General Foods Corp. v. Commissioner*, 4 T.C. 209 (1944), *acq.* 1946 C.B. 2.

While a result in accord with this argument by the Government would undoubtedly result in recovery by Goodyear of most of its refund claim, the audit problems in calculating it are extremely complex, and the problems confronted by U.S. companies generally having foreign subsidiaries, which would all need to be re-audited for all open years, would make the reversal of the *General Foods* case at this late date most unfortunate.

Under all the circumstances it seems advisable for Goodyear to argue here in favor of section 902 as in effect for the years from 1970 through 1973, rather than in favor of the Tax Reform Act of 1986.

SUMMARY OF ARGUMENT OF GOODYEAR

In order to avoid double taxation of the profits of a foreign subsidiary of a U.S. corporation by both the foreign country in which it is located and by the United States (upon the payment of taxable dividends by the subsidiary), section 901 grants a credit against U.S. tax for the foreign taxes deemed paid by the U.S. corporation. Section 902 provides that the amount of foreign taxes "deemed paid" by the U.S. parent is to be in the same ratio to the foreign taxes paid by the foreign subsidiary as the dividend bears to the "accumulated profits" of the foreign subsidiary in excess of the foreign taxes. Case law provides that the determination of the

ratio is to be made on a year by year basis. Thus each dividend must be "sourced" or attributed to a particular year's accumulated profits so that the ratio of the dividend out of accumulated profits of that year to total accumulated profits of that year can be determined and applied to that year's foreign tax to determine the appropriate credit.

It is the contention of Goodyear that the statutory language, the fulfillment of the statutory purpose of avoiding double taxation and the relevant authorities require that the *sourcing* of the dividend out of each year's accumulated profits be made by reference to the foreign corporation's gains, profits and income as determined by the foreign country in which the subsidiary is taxed. This method results in a *matching* of each year's foreign tax and that year's accumulated profits on which the foreign tax was imposed and out of which the dividend is treated as paid under the sourcing principle.

The Government's argument that the accumulated profits are to be computed and sourced like the taxable income of a U.S. taxpayer can, and does, result in a mismatching of annual "accumulated profits" and the actual foreign tax, with double taxation as an inescapable consequence. Further, the Government's position rests solely on an asserted administrative practice which is *not* supported by its own Regulations or a consistent rulings policy. For these reasons, the decision of the Court of Appeals for the Federal Circuit should be affirmed.

ARGUMENT

I. When the British tax authorities determined (1) that Goodyear England had a loss in 1973 and (2) that the loss should be carried back as a deduction to 1971 and 1970, those determinations should have been reflected in the recomputation of the foreign tax deemed paid by Goodyear with respect to its 1970 and 1971 dividends received from Goodyear England.

A. Introduction.

At the time of the Claims Court and Court of Appeals proceedings, the parties here were in agreement as to the general structure of the statutory and Treaty arrangements for computing the tax appropriate to a dividend. They agreed on the formula to be used in determining the tax appropriate to the dividend. They agreed on the accepted rule that a dividend must be "sourced" in appropriate cases to earlier tax years of the foreign corporation to determine the amount of foreign tax paid on the profit out of which the dividend was paid. They agreed that when a foreign tax is refunded, the "tax deemed paid" on the dividend must be completely recalculated taking into account all appropriate adjustments. They disagreed, however, on whether, in sourcing the dividend to earlier years, the U.S. tax authorities must find the profit in the years where the foreign tax authorities found it and taxed it, or whether they may reconstruct the income of the foreign corporation as if it had been a U.S. corporation and U.S. tax rules had applied.

It is important to understand that for the U.S. tax authorities to recognize and apply the determinations made by the British does not mean that the U.S. Internal Revenue Service must conduct an audit of the British corporation, attempting to apply British law. On the contrary it means that the U.S. authorities should recognize the amount of British profit, and the year in which it was taxed, as the British tax authorities determined it, and should no more attempt to revise that determination than they would attempt to revise the timing and

amount of the British tax. The statement by the Government of the Question Presented for Review is a little misleading with respect to this point.

B. The structure of the foreign tax credit.

The solution to this case may seem more obvious once the system of calculating the "indirect" or "deemed paid" credit is clearly understood. For that reason a large part of this brief will be devoted to an attempt to explain that system as clearly and simply as its complicated nature permits. In particular five concepts must be grasped:

(1) The resemblances and differences between the "direct" and "indirect" foreign tax credits.

(2) The basic formula for computing the "tax deemed paid."

(3) The concept of "grossing up."

(4) The concept of "sourcing."

(5) The overall limit on the amount of foreign tax credit allowable.

1. Definitions of terms. At this point it is necessary to define several phrases used in the Code:

a. "Income," "gross income," "net income," "taxable income": These are all terms used in computing the income of a U.S. taxpayer subject to U.S. tax. The dividends Goodyear received in 1970 and 1971 from Goodyear England were includible in its U.S. parent's "gross income" for those years.

b. "Gains, profits, or income," "profits or income": These terms are used generally in the foreign tax credit provisions of the Code (*e.g.*, section 902(c)) to refer to the amount with respect to which a foreign country imposes its "income, war profits or excess profit taxes" on a foreign corporation. They are not used anywhere in the Code in referring to income subject to U.S. tax. The Claims Court (the trial court here) and the Court of Appeals *both agreed* that this term referred to the *foreign* taxable income. Cert. App. at 6a, 26a.

c. "Earnings and profits": This term is used in the Code (*e.g.*, section 312) to refer to something analogous to "surplus" under the corporation laws. While the Code may refer to the "earnings and profits" of the current year, the term more often refers to the "earnings and profits" on hand from all years. The term is important chiefly in determining whether a corporate distribution received by a shareholder is ordinary income or a distribution of capital. It is not mentioned in the Stipulation.

d. "Accumulated earnings," "accumulated earnings and profits": These are terms defined in connection with the tax imposed by Code sections 531 *et seq.* on income accumulated by a corporation beyond the needs of its business, but have nothing to do with the foreign tax credit.

e. "Accumulated profits": This term is applied exclusively to foreign corporations in connection with the "deemed paid credit" under section 902 with which we are concerned here. Indeed it is used in the Code *only* in section 902 and related sections. In contrast to "earnings and profits" it does not refer to an accumulation from previous years; notwithstanding its peculiar label, it refers to each year separately and means the "gains, profits or income" for that year without reduction for the foreign taxes imposed on or with respect to it. Section 902(c)(1).

2. While the indirect tax credit is intended to carry out the same general purpose (of avoiding double taxation) as the direct tax credit, it differs in important respects which relate to the issue here. Section 901 of the Code allows to U.S. taxpayers a credit (the "direct" credit) against U.S. tax for income taxes paid by U.S. taxpayers to a foreign country. It also allows to U.S. corporate taxpayers a similar credit (the "indirect" credit) for taxes paid by a foreign corporation (and "deemed paid" by the U.S. taxpayer) as provided in section 902. Section 902 applies where the U.S. taxpayer

receives dividends from a foreign corporation out of income of the foreign corporation already taxed in the foreign country. In order to understand this case, it is necessary to understand how both credits are determined.

a. The direct credit. If Goodyear had operated a branch in England, rather than a separate subsidiary corporation, it would have had to file tax returns in its own name in Great Britain as well as in the United States. If it had earned $1,000 in Britain in any of the years here involved it would have paid a tax of $400 (40%) to Britain.[4] It could then, if it so elected, report the entire $1,000 in U.S. income, taking no deduction for the foreign tax, but crediting the British tax against the U.S. tax. The U.S. rate being 48%, the gross U.S. tax of $480 would be reduced to $80 by the credit of $400. Note that out of $1,000 of earnings in Britain, 40% has gone to Britain and 8% to the U.S. *The relationship of these rates is the touchstone in Goodyear's argument that consistent results should be reached under section* 902.

Even if the U.S. concluded that the foreign income should be in a different amount or should fall in a different year, the timing and amount of the *direct* credit would not be affected. Subject to section 904 (which limits the amount of both the direct and the indirect credits to an amount equivalent to the U.S. rate of tax), *all the foreign tax paid arising from a branch operation is recovered as a direct credit in the year to which it relates.* This means that if Goodyear had operated in England through a branch rather than through a subsidiary, it would already have received full credit in

[4] For purposes of all the examples set forth in this brief, the United States rate of taxation will be assumed to be 48% and the British rate of taxation will be assumed to be 40%, except where otherwise expressly stated. These are the actual comparative rates of taxation involved in the present case.

1968, 1969, 1970 and 1971 for the taxes at issue here and the problem in the present case could not have arisen.

b. The indirect credit. But Goodyear does not operate in England. It does have a subsidiary there, Goodyear England, which pays its own British tax on its own earnings as computed to the satisfaction of the British tax authorities. The subsidiary's U.S. parent is not concerned with the British tax until it receives a dividend from its subsidiary. When it does so it claims an "indirect credit" for the "appropriate amount" of "tax deemed paid" to Britain on the profits from which the dividend was paid.

Thus the indirect credit differs from the direct credit in two major respects:

(1) The indirect credit becomes available *only upon receipt of a dividend,* which may occur years after payment of the foreign tax.

(2) The indirect credit is allowed only for foreign taxes paid *on the profit out of which the dividend was paid.*

The issue here is how to determine the "profit out of which the dividend was paid" when we know the foreign tax paid on it. That issue does not arise with the direct credit.

3. The basic formula for computing the tax deemed paid. The United States-United Kingdom Tax Treaty is designed to prevent double taxation. Article XIII of the Treaty provided in part:

> [I]n the case of a United States corporation owning at least 10 percent of the voting power of a corporation resident in the United Kingdom, [the United States] shall allow credit for the *appropriate amount of United Kingdom tax paid by the corporation paying such dividend with respect to the profits out of which such dividend is paid, if the recipient of such dividend includes in its gross income for the purposes of United States tax the amount of such United Kingdom tax*. . . . [Convention for the Avoid-

ance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, April 16, 1945, U.S.-U.K., Art. XIII(1), as amended by Supplementary Protocol signed March 17, 1966] [Emphasis supplied]

Sections 901 and 902 of the Code apply these Treaty provisions to U.S. taxpayers. The indirect credit under the Treaty is the "appropriate amount of United Kingdom tax." The Treaty does not further define that phrase, but it is clear that the Treaty describes dividends as being paid *out of profits* and that the credit is based on the tax with respect to *those profits*.

Section 902 (as in effect in 1971, 1972, and 1973 and substantially as in effect in 1970) provided in part, as to dividends from foreign corporations other than in less-developed countries:

> (a) Treatment of Taxes Paid by Foreign Corporation. — For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall —
>
> (1) to the extent such dividends are paid by such foreign corporation *out of accumulated profits* . . . be deemed to have paid the same proportion of any income . . . taxes paid . . . by such foreign corporation to any foreign country . . . on or with respect to *such accumulated profits*, which the amount of such dividends . . . bears to the amount of *such accumulated profits* in excess of such . . . taxes . . . . [Emphasis supplied]

This gives us the basic formula: for any dividend received by a domestic shareholder of a foreign corporation, the tax deemed paid by the domestic shareholder is the net dividend paid by the foreign corporation divided by the "accumulated profits" of the foreign corporation after tax, and multiplied by the foreign tax paid by the foreign corporation *on those accumulated profits*. This formula may be abbreviated as TD/P, where T is the foreign tax for a year, D is the dividend paid by the foreign corporation out of the accumulated profits of that year, and P is the "accumulated profits" of the foreign corporation for that year after tax. The tax referred to in the formula is the tax *on those "accumulated profits"* and the "accumulated profits" in the denominator are the *same* "accumulated profits" after deducting the *same* tax.

4. The concept of "grossing up." The language in the Treaty requiring the U.S. parent to include in its gross income the amount of the United Kingdom tax refers to the principle called "grossing up." At this point it is appropriate to mention *American Chicle Co. v. United States*, 316 U.S. 450 (1942), not only because it is this Court's only previous consideration of the "tax deemed paid" credit, but also because it led to the "grossing up" concept.

The problem in *American Chicle* may be explained briefly by assuming that a foreign corporation earns $1,000, pays a 40% tax of $400, and in the same year distributes the remaining $600 as a dividend to a U.S. corporation, whose tax rate is 48%. The U.S. corporation claims a credit of $400 against the U.S. tax on the dividend. The gross U.S. tax on the $600 dividend would be $288 and the credit would exceed the U.S. tax. Something was clearly wrong. The Government argued successfully that the U.S. corporation was claiming a credit not only for the foreign tax attributable to the dividend but also for the foreign tax attributable to the funds used to pay the foreign tax. So the decision in effect reduced the credit in the example by 40% of the foreign tax, or $160, leaving a credit of $240. The total tax paid on the original $1,000 was now $448, $400 to the foreign government and $48 to the U.S. The apparent rate of total tax was now 44.8%.

Something was still not quite right with the formula, and the debate went on. The Treaty was en-

tered into in 1946, and the Code was amended by the Revenue Act of 1962, Pub. L. No. 87-834, § 20(a), 76 Stat. 960, and we now have a new solution: the Treaty and Section 78 of the Code require that the foreign tax deemed paid be *added to the dividend* (the "grossing up" concept). Now in the example above the U.S. shareholder reports a dividend of $1,000 ($600 distribution plus $400 tax deemed paid), a gross U.S. tax of $480 and a net U.S. tax (after allowing the foreign tax credit of $400) of $80. The total tax paid out of $1,000 of income earned is $480, or 48%, which is just what it should be, and the entire foreign tax of $400 has been recovered as a credit. Double taxation has been avoided and the net results match the branch taxes.

5. The concept of sourcing. It might be supposed that in applying the formula TD/P, P might refer to an aggregate amount of after-tax profit for all years (as indeed the term "accumulated profits" seems to suggest) and that T would represent the sum of the taxes for all years. The Government's brief makes this assumption here, and one taxpayer so argued when the quoted term was new, but the Tax Court held otherwise. *General Foods Corp. v. Commissioner*, 4 T.C. 209 (1944), *acq.* 1946 C.B. 2. The Tax Court held (and this is now well-settled) that the calculation was to be made on an annual basis; that is, the fraction TD/P was to be computed for each year, P being the after-tax profit of a given year, T the foreign tax on *that* year's profit, and D the amount of the dividend paid out of *that* year's profit, whether or not paid *in* that year. The court said:

> To properly give effect to the language of the [statute], it is necessary to relate the tax credit to the particular year or years in which the accumulated profits (from which the dividends were paid) were earned and taxed. [4 T.C. at 216]

The concept of "sourcing," *which is critical to the present case,* in effect requires segregating the foreign subsidiary's income — its "accumulated profits" before

tax — by years. It is as if each year's profit is put in one of a row of pigeonholes in an old-fashioned desk. Out of each year's profit the foreign tax on it is paid and the receipt for the corresponding foreign tax is put in the corresponding one of a parallel row of annual tax pigeonholes. To find the numbers for the formula in section 902, the dividend is first assigned to the pigeonhole for the year in which the dividend was paid. Section 902(c)(1). If there is enough profit there to cover the dividend, we simply determine the fraction D/P by dividing the dividend by the profit. This fraction is multiplied by the tax in the corresponding pigeonhole for the same year to determine the tax deemed paid.

If, on the other hand, the dividend paid exhausts the profit for the year to which it was initially assigned, the rest of the dividend takes some of the profit from the pigeonhole for the next preceding year. Thus the "tax deemed paid" will be all of the tax corresponding to the first pigeonhole and part of the tax proportionate to the profit in the pigeonhole for the previous year.

It will be readily seen that this method will ordinarily produce a fair allocation for each year. Example 1 shows the result if a $300 dividend is "sourced" to two years:

Example 1

Year	1		2
Gains, profits or income of foreign corporation	$ 600		$ 400
Foreign tax	− 240		− 160
Accumulated profits after tax	360		240
Dividend			300
TD/P	$\frac{(240 \times 60)}{360} = 40$		$\frac{(160 \times 240)}{240} = 160$
Total tax deemed paid	= 40 + 160	=	+ 200
Grossed-up dividend			500
Gross U.S. tax at 48%			240
Less credit for tax deemed paid			− 200
Net U.S. tax			40

The "tax deemed paid" is 40% (the assumed foreign rate) of the "grossed-up" dividend, and the effective combined tax burden will ordinarily approximate that on a branch operation. *See supra* p. 12. The Treasury Regulation applicable to the present case illustrates the sourcing principle at Treas. Reg. § 1.902-5(e), Example (1).

Three points must be noted. First, the use of the "pigeonhole" approach of the *General Foods* case is not needed for the calculation of foreign tax credits for a *branch* operation. In a branch operation the U.S. corporation reports its foreign income every year and claims its foreign tax credit every year. With a subsidiary, the income is reported only when it is distributed, and it is then that the *General Foods* case requires that the income and taxes of the foreign corporation be allocated to the pigeonholes representing the current and past years.

The second point to be noted is that when the total dividend exceeds P, D in the formula does not represent the total amount of the dividend. It represents only the part of the total dividend which is assigned —"sourced" — to that year. Thus the computation is repeated each year with a different T, a different D, and a different P, and the results — the taxes deemed paid for each year — are added to produce the total tax deemed paid. There should be no difference of opinion between Goodyear and the Government up to this point.

Third, while tax receipts are simply assigned to the pigeonholes for the years with respect to which the taxes were assessed, the essential issue here is how best to allocate the "gains, profits and income" to the right pigeonholes so that they are paired with the foreign tax imposed on them. Goodyear contends that if the gains, profits and income assigned by the foreign taxing authority to any pigeonhole are changed to a different pigeonhole or changed in amount, the principle of sourcing is violated and distortion of the credit and

double taxation result. In Goodyear's view the Code, Treasury Regulations and decided cases support this conclusion.

The Tax Court recognized the significance of pairing the "gains, profits and income" of a foreign corporation with the tax imposed on them for purposes of the section 902 credit. In *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53 (1972), *aff'd mem.*, 500 F.2d 1399 (3d Cir. 1974), the Tax Court stated:

> It is of critical importance to determine the "accumulated profits" of each year, so that they can be matched against the foreign taxes paid for *that* year, and so that when dividends are paid "out of" or "from" such "accumulated profits," a foreign tax credit may properly be computed as a portion (in accordance with the statutory formula) of the foreign taxes paid in respect of the "accumulated profits" of *that* year. [59 T.C. at 79] [Emphasis by the court]

In *Champion International Corp. v. Commissioner*, 81 T.C. 424 (1983), *acq.* 1984-2 C.B. 1, *acq. partly withdrawn* Rev. Rul. 87-72, 1987-2 C.B. 170, the Tax Court again noted that the section 902 credit must be computed in a manner that correlates the foreign tax with the profit on which that tax was paid and out of which the dividend was distributed:

> The purpose of U.S. tax principles in the context of section 902 is to establish a correlation between the foreign taxes paid on the foreign subsidiary's accumulated profits of a particular year and the dividends paid from the same year's accumulated profits. *To ignore the fact that foreign law computes the tax liability by allowing for loss carrybacks is to assure that this correlation will be lost.* [81 T.C. at 440] [Emphasis supplied]

The problem in the present case arises when the foreign government, in imposing its tax, computes the "gains, profits and income" subject to tax in a given year

as a different amount from what would have been the "taxable income" of the subsidiary if it had been a United States corporation paying United States taxes. *This is the point at issue in the present case,* as reflected in Exhibits I and J to the Stipulation, where the positions of the parties are set out in paragraphs 23 and 24. *See* J.A. at 26-27, 30-31.

6. The overall limit on the amount of foreign tax credit available. Section 904(a) of the Code provided that the credit should not exceed the same proportion of the tax against which the credit is taken (the U.S. tax) which the taxpayer's income from the foreign country bears to the taxpayer's total income. At the taxpayer's option this formula could be applied either on a country by country basis or by using *all* foreign taxes and *all* foreign income.

This limit applies both to the direct credit (as in a branch operation) and to the indirect credit (as in a subsidiary operation). The effect of it is to prevent the U.S. taxpayer from claiming credit for foreign taxes at rates of tax exceeding U.S. rates. It has no application here, but is mentioned to avoid confusion with the similar section 902 formula.

C. Revising foreign determinations of "accumulated profits" by applying U.S. rules causes distortion and double taxation.

It is not disputed that Goodyear correctly included in its gross income as dividends *all* the distributions it received from its British subsidiary. It is not asserted by the Government that Goodyear claimed as foreign tax credits more British taxes than those actually paid and not previously credited or refunded. It is not disputed that if Goodyear England had been a branch, all those British taxes would have long since been allowed as credits against U.S. tax. It is not disputed that if Goodyear wins this case it will be allowed credit for British taxes it actually paid in 1968, 1969, 1970 and 1971. Ex. I,

J.A. at 30. Then what is the dispute about? Only that the Government seeks, by one means or another, to recalculate the foreign income so as to disconnect it from the foreign tax and prevent the credit. In computing P (accumulated profits after tax) in the formula TD/P for each year, the Government has argued (at least in the lower courts) that "accumulated profits" means taxable income computed under U.S. rules, as if Goodyear England had been a U.S. corporation.

To put the simplest possible case, suppose that a British subsidiary reports to the British taxing authorities under British law that it earned $1,000 in year 1, paying $400 tax, and earned nothing in year 2, although it paid a $600 dividend in year 2. Suppose further that the U.S. rules would put the $1,000 profit in year 2:

Example 2

Under British Rules:[5]

Year	1	2
Profit	$1,000	0
British tax	– 400	– 0
Accumulated profits after tax	600	0
Dividend		600

TD/P = 400 × 600/600 = 400

Under U.S. Rules:

Year	1	2
Profit	0	$1,000
British tax	– 400	– 0
Accumulated profits after tax	– 400	$1,000
Dividend		600

TD/P = 0 × 600/1000 = 0

[5] We have used "British rules" throughout this brief as a short-hand label for results that follow under section 902 from a decision to allocate the gains, profits and income where the British taxing authorities did, as set out in paragraph 6 of the Stipulation. J.A. at 11.

Computation of U.S. Tax and Credit

	British Rules	U.S. Rules
Net dividend	$ 600	$ 600
Tax deemed paid	+ 400	+ 0
Grossed-up dividend	$1,000	$ 600
Gross U.S. tax (48%)	480	288
Credit	− 400	− 0
Net U.S. tax	80	288
Total tax paid to both countries out of $1,000 earned	480	688
Effective combined rate of tax on $1,000 of foreign profit	48%	68.8%

Under the Government's theory the dividend would be treated as paid out of "profits" of year 2 so that there would be no foreign tax to claim as a credit and the U.S. tax would be $288. There was a tax in year 1 but that tax, in the Government's view, was imposed on no income and is lost forever.

Essentially double taxation occurs whenever the effective combined rate of taxation (such as 68.8% in the example) exceeds the tax either country would impose on income taxed by it alone. An effective combined rate of 48% avoids double taxation and corresponds with the total tax on a branch operation.

Example 2 presents the very essence of Goodyear's case. Since section 902 in effect provides that in the fraction TD/P as applied to each year to which the dividend is sourced —

P is the accumulated profit less the tax on *that profit,*

T is the tax on *that profit,* and

D is the dividend paid out of *that profit,*

it should be obvious that all three elements are interrelated and that to shift any one of them to a different year can create a distortion resulting in double taxation, contrary to the Treaty and section 902.

The same kind of distortion inevitably arises when, as here, there is a net operating loss. Such a loss is carried back and deducted under British law in the *first*

preceding year in which there was a profit, and then in the second; but under U.S. law it is carried back and deducted first in the third preceding year. I.R.C. § 172. Thus if U.S. rules apply in computing P, the reduction in profit is in one year but the reduction in tax is in another. Distortion is inevitable. This gives us the following example:

Example 3

Year	1	2	3	4
Profit	$1,000	$1,000	$ 1,000	−$1,000
British tax	−400	−400	−400	−0
Accumulated profits after tax	600	600	600	−$1,000
Carryback deduction allowed in preceding year under British rules:				
Reduction in profit	0	0	−1,000	
British tax refunded	0	0	+400	
Accumulated profits after tax	600	600	0	
A dividend of $300 in year 4 is considered paid out of accumulated profit of year 2				$300
Tax deemed paid = TD/P = 400 × 300/600 = 200				
Carryback deduction allowed in third preceding year under U.S. rules:				
Reduction in profit	−1,000	0	0	
British tax refunded	0	0	+400	
Accumulated profits after tax	−400	600	1,000	
A dividend of $300 in year 4 is considered paid out of accumulated profit of year 3				$300
Tax deemed paid = TD/P = 0 × 300/1000 = 0				

Computation of U.S. Tax and Credit

	British Rules	U.S. Rules
Net dividend	$ 300	$ 300
Tax deemed paid	+200	+0
Grossed-up dividend	500	300
Gross U.S. tax (48%)	240	144
Credit	−200	−0
Net U.S. tax	40	144

In Example 3 the dividend is "sourced" under U.S. rules to year 3, where there is no tax to claim as a credit, while the $400 tax paid in year 1 can never be recovered

as a credit because no dividend can ever be "sourced" to that year. Despite the obvious distortion, the Government argues that this is the correct rule.

A problem like Example 3 can arise (and does in the present case) out of other deductions and income differences as well. Suppose the foreign corporation buys tire molds that are depreciated at the rate of 50% in the year of purchase and 50% the next year, as in Exhibits M-R (J.A. at 32-59), while U.S. rules would require depreciation over three years. The comparative calculations, using hypothetical numbers, will be as follows:

Example 4

Using British Rules:

Year	1	2	3
Profit before accounting for molds	\$ 1,000	\$ 1,000	\$ 1,000
Deduction for molds (British rules)	−150	−150	0
British tax	−340	−340	−400
Accumulated profits after tax	510	510	600
Dividend	300	300	300
Tax deemed paid = TD/P	$\frac{340 \times 300}{510} = 200$	$\frac{340 \times 300}{510} = 200$	$\frac{400 \times 300}{600} = 200$
Grossed-up dividend	500	500	500
Gross U.S. tax on dividend (48%)	240	240	240
Credit	−200	−200	−200
Net U.S. tax	40	40	40
Net U.S. tax rate on gross dividend	8%	8%	8%

Using U.S. Rules:

Year	1	2	3
Profit before accounting for molds	\$ 1,000	\$ 1,000	\$ 1,000
Deduction for molds (U.S. rules)	−100	−100	−100
British tax	−340	−340	−400
Accumulated profits after tax	560	560	500
Dividend	300	300	300
Tax deemed paid = TD/P	$\frac{340 \times 300}{560} = 182.14$	$\frac{340 \times 300}{560} = 182.14$	$\frac{400 \times 300}{500} = 240$
Grossed-up dividend	482.14	482.14	540
Gross U.S. tax on dividend (48%)	231.43	231.43	259.20
Credit	−182.14	−182.14	−240.00
Net U.S. tax	49.29	49.29	19.20
Allowed foreign tax rate on gross dividend	37.8%	37.8%	44.4%
Net U.S. tax rate on gross dividend	10.2%	10.2%	3.5%

In Example 4 where the actual amount of British tax paid (T) is fixed for each year under British rules, as it must be, but the "accumulated profit after tax" (P) is recomputed under U.S. rules, as the Government says it should be, we see that

—The British statutory tax rate is the same in all three years (40%);

—But the British rate allowed by U.S. rules is 37.8% of the grossed-up dividend in the first two years and 44.4% in the last.

—The actual dividend paid is the same in all three years (\$300);

—But the net U.S. tax in the first two years is more than 10% of the income under U.S. rules and in the last year is less than 4%.

Something must be wrong. What is it? We think the answer is plain. If we compare the *actual* British tax in dollars with profit recomputed under U.S. rules, we generate a synthetic tax rate in no way related to reality. This is why in the fraction TD/P both T and P must be computed under the same set of rules. Whenever there

is a difference in the computation of the profit, the foreign tax, or the portion of a dividend sourced to a year depending on whether U.S. or foreign law is applied, distortion and potential double taxation result because the *amount* of the British tax is 40% of the *amount* of gains, profit or income *as computed by the British*.

Exhibits I and J to the Stipulation show the end result of the opposing parties' arguments as applied to the actual facts of the present case. The *actual* foreign tax assessed for each year and the amount on which the United Kingdom imposed its tax rate were as follows (Ex. I, J.A. at 30) (all amounts being shown in pounds sterling):

	Tax	U.K. Income	Effective Rate
1968........	£1,752,096	£3,947,459	44.4%
1969........	833,251	1,932,178	43.1%
1970........	758,437	1,866,923	40.6%
1971........	-0-	-0-	N/A
Total	£3,343,784	£7,746,560	43.2%

The deviation in the effective rates from 40% merely reflects the Irish income and tax.

We may compare the above average effective tax rate percentages with those produced under the competing theories of Goodyear and the Government as shown on Exhibits I and J (J.A. at 30-31):

	Goodyear 1970	Goodyear 1971	U.S. 1970	U.S. 1971
Net dividend paid....	£ 946,521	£ 729,289	£ 946,521	£729,289
Tax deemed paid	+642,449	+586,961	+235,038	+12,086
Grossed-up dividend	1,588,970	1,316,250	1,181,559	741,375
Ratio of British tax deemed paid to grossed-up dividend	40.4%	44.6%	19.9%	1.6%

The effective rates resulting from application of Goodyear's theory are fairly close to the actual British rates and produce a credit fairly close to what was intended by the Treaty and the Code and to the credit

that would have been allowed for a branch operation. But surely when the British and the Irish actually were taxing Goodyear England at an effective rate of over 40%, the allowance of credits based on assumed foreign rates of 19.9% and 1.6% is not the way to avoid double taxation. The Government's method of sourcing moves income from one pigeonhole to another without moving the tax imposed with respect to it.

The foregoing discussion and examples make it plain, we think, that *if "accumulated profits" is computed under U.S. rules, whatever differences result will be in derogation of the basic purpose of the formula set out in section 902(a) of the Code.* And the Government has never really attempted to defend this distortion, merely implying that it is the unfortunate effect of the statute. But is it?

D. "Accumulated profits" cannot be held to mean "earnings and profits."

1. Section 902 does not support such a conclusion. The Government, in arguing on page 20 of its brief that "accumulated profits" and "earnings and profits" are synonymous terms quotes from section 902(a)(1) language which it argues "must be read in the same way" as language quoted from the definition of a dividend in section 316. But both of the quotations are incomplete, and the complete language of the two sections proves exactly the opposite.

Section 316(a) provides that

> *For purposes of this subtitle, the term "dividend" means any* distribution of property *made by a corporation to its shareholders* —
>
> (1) Out of its earnings and profits *accumulated after February 28, 1913, or*
>
> (2) *Out of its earnings and profits of the taxable year . . . .*

This statute rather clearly means that if a distribution is *not* out of earnings and profits, it is not a dividend, a generally accepted conclusion.

Section 902(a)(1) on the other hand begins

(1) *to the extent such* dividends *are* paid *by such foreign corporation* out of accumulated profits . . . .

The language of the two sections (with the italicized omissions restored) clearly contemplates that there can be a distribution of *earnings and profits* (a dividend) which is *not* out of *accumulated profits*. The omission in the Government's brief of "to the extent such" in section 902(a)(1) and of "the term dividend means any" from section 316(a) obscures the contrast between "earnings and profits" and "accumulated profits." There is no escaping the conclusion: "earnings and profits" and "accumulated profits" are two different things.

Moreover, the term "earnings and profits" was used elsewhere in the tax law before the Revenue Act of 1918, Pub. L. No. 65-254, § 240(c), 40 Stat. 1082, introduced the indirect tax credit. So why did Congress not use it instead of "taxable profit" and "accumulated profit?" *See infra* p. 30 for a discussion of the Revenue Act of 1918. Might it not have been because "earnings and profits" measured the *U.S.* income of the parent that received a dividend, and Congress wanted to use a different term to refer to the foreign income base on which the foreign tax was imposed?

Furthermore, whether "accumulated profits" refers to British taxable income or U.S. taxable income, it unquestionably refers to income *on which* a tax is imposed, *not* "earnings and profits."

2. "Earnings and profits" is not an available alternative under the Stipulation in this case. In any event the Government's case here, under the Stipulation, is that "accumulated profits" means income computed as it would be for a U.S. taxpayer; there is no room here for an argument that it is "earnings and profits." This point has already been discussed at page 5 above.

3. Congress itself in 1986 used the terms "accumulated profits" and "earnings and profits" in the same statute with contrasting meanings. In the Tax Reform Act of 1986, the new Code section 902, which effectively replaced the section involved in the present case, adopted the position argued unsuccessfully for the taxpayer in *General Foods Corp. v. Commissioner*, 4 T.C. 209 (1944), *acq.* 1946 C.B. 2 (discussed *supra* pp. 16-18), that the accumulated profits and the foreign tax are to be taken in the aggregate — that the tax deemed paid is that proportion of the aggregate which the dividend bears to the aggregate undistributed "earnings and profits." The Act of 1986 eliminates the "pigeonhole" method of "sourcing" for the future since year-to-year distortions will now be eliminated by averaging so that whether future "accumulated profits" are computed under foreign or U.S. law will no longer be important. But the term "accumulated profits" is nevertheless retained for computation of the credit on dividends out of *pre-1987* undistributed earnings.

Why, in the Act of 1986, did Congress use "accumulated profits" in the provision applicable *before* 1987 and "earnings and profits" in the provision applicable *after* 1986 if the two phrases were synonymous? Apparently because they were not.

E. The statutory definition of "accumulated profits" in section 902(c) clearly provides that "accumulated profits" refers to the foreign tax base.

Subsection 902(c)(1)(A) provides:

(c) Applicable Rules —

(1) Accumulated Profits Defined. — For purposes of this section, the term *"accumulated profits" means* with respect to any foreign corporation —

(A) . . . . the amount of its *gains, profits, or income* computed without reduction by the amount of the income, war profits, and excess profit taxes *imposed on or with respect to such profits or income* by any foreign country or any possession of the United States; . . . [emphasis supplied]

This clearly says that the amount of the accumulated profits equals the amount of the gains, profits or income on which the foreign tax was imposed. If "gains, profits or income" does not refer to the foreign tax base, then Britain is applying its tax rate to U.S. "taxable income."

In a predecessor of section 902, section 240(c) of the Revenue Act of 1918, Congress used the term "taxable income" of the foreign subsidiary to refer to the denominator of the deemed paid credit fraction (P). Taxable by whom? That income is not taxable in the U.S. "Taxable income" *must* refer to income taxable by the foreign country. Such income is of course measured by the foreign taxing authority just as the "taxable income" of a U.S. taxpayer is measured in U.S. terms. *United Dyewood Corp. v. Bowers*, 44 F.2d 399 (S.D.N.Y. 1930), *aff'd per curiam*, 56 F.2d 603 (2d Cir. 1932). Although section 238(e) of the Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 259, replaced the term "taxable income" with the term "accumulated profits," nothing in the legislative history of the Revenue Act of 1921 suggests that Congress intended to switch to a U.S. tax concept when it substituted the term "accumulated profits" for "taxable income."

F. The opinion of this Court in *American Chicle Co. v. United States* implies that "accumulated profits" means the foreign tax base.

Did Congress mean by this change in the formula from "taxable income" in the Act of 1918 to "accumulated profits" in the Act of 1921 to change the meaning from the tax base of the foreign country to a simulated U.S. tax base in the formula?

Apparently not in the view of this Court when it drafted its opinion in *American Chicle Co. v. United States*, 316 U.S. 450 (1942), where it said the subsidiary's accumulated profits are its "total taxable profits less taxes paid." *Id.* at 452. Thus "accumulated profits" apparently still refers to the foreign tax base.

G. The Treasury Regulations do not dictate a contrary result.

The Regulations in effect for the years 1970 through 1975 were those that were adopted in 1965 to apply to the Revenue Act of 1962, which introduced "grossing up." References to the Regulations in this brief will refer to those Regulations, except where otherwise indicated.

Treas. Reg. § 1.902-3(a)(2) sets out the formula for computing the credit essentially in the words of the statute, giving credit for the foreign tax paid "on or with respect to" the accumulated profits in the proportion that the dividend bears to the same accumulated profits. So far, the Regulation paraphrases the statute.

The same Regulation goes on to say, in § 1.902-3(c)(4):

> Since . . . *the accumulated profits*, determined in accordance with subparagraph (1) of this paragraph, for the taxable year *are always equal to the total amount of the gains, profits, and income* for such year, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year *on or with respect to* such gains, profits, and income. [Emphasis supplied]

And in Example (2) in Treas. Reg. § 1.902-5(e) a foreign rate of 40% is applied to "gains, profits and income" of $100 to produce a foreign tax of $40, clearly confirming that "gains, profits and income" is the base on which the foreign government computes its tax.

Treas. Reg. § 1.902-3(c)(1) on the other hand provides that the "accumulated profits" is the sum of the "earnings and profits" of the taxable year and the foreign taxes imposed on the "gains, profits and income" to which the "earnings and profits" are attributable. This reference to "earnings and profits" appears for the first time in the Regulations in 1965 and appears only in the part of the Regulations applicable to post-1965 distribu-

tions. Does this reflect a change in the law? It would appear not as there is no change in the Revenue Act of 1962 in this respect.

We think the purpose of the isolated reference to "earnings and profits" in Treas. Reg. § 1.902-3(c)(1) was to deal with a situation in which the "gains, profits and income" after tax (foreign rule) exceeded the aggregate "earnings and profits." Since section 902 is explicitly limited to cases where a dividend has been received by the parent and since a distribution in excess of aggregate "earnings and profits" is not a dividend, there must be excluded from P the amount of the non-dividend distribution. The Regulation does *not* purport to say that where there is a dividend it is to be "sourced" under U.S. rules.

Let us look at this language with some specific figures in mind. Let us suppose that the foreign corporation has "gains, profits and income" (the foreign tax base) of $1,000 and pays a tax of $400, leaving $600. Let us suppose further that the "earnings and profits" (the amount that determines what portion of a distribution is a dividend and what portion is a return of capital) is $500. Finally let us suppose a distribution of $1,500.

The distribution in question is a "dividend" — taxable to the U.S. recipient — to the extent of the earnings and profits, which is $500. This is so regardless of the amount of "gains, profits and income" the British recognized.

The "accumulated profits" after tax, according to Goodyear's theory, were $600. But the section 902 credit is available only to the extent that there is a dividend, in this case $500, the amount of the earnings and profits. D in the formula is therefore $500.

When we look at the rest of paragraph (c)(1) of the Regulation, however, we see that we are to add to the $500 the taxes imposed on the gains, profits and income to which the earnings and profits are attributable, not the entire amount of the taxes on the entire

$600 of accumulated profit after tax, but the taxes attributable to the $500 portion of the $600 distribution that constituted a dividend. This appears to be the problem dealt with in Treas. Reg. § 1.902-3(c)(1). It is not relevant to the present case, in which the entire amount of each distribution in question is conceded to be a taxable dividend.

All of this is consistent with section 902(c)(1), quoted above. As the Claims Court concluded in its opinion:

> The relation of "gains, profits and income" to foreign income taxes indicates this tax concept *is to be equated with foreign taxable income.* [Emphasis supplied] [Cert. App. at 26a]

And the Court of Appeals reached the same conclusion, saying:

> These provisions establish that "P" *is the actual basis on which the foreign sovereign assesses tax liability.* Because "T" is the actual tax imposed by the foreign government, "P" must also be the basis to which the foreign government applies its own tax law in computing "T". Rev. Rul. 74-310, 1974-2 C.B. 205 (foreign income tax to be used in section 902 computation is amount of tax imposed on total profits as measured by foreign standards). For this reason, *we find the plain meaning of the statute requires "P" to be determined under foreign law.* [Emphasis supplied] [Cert. App. at 6a]

The conclusion seems indisputable: in "sourcing" the income of a foreign corporation, "accumulated profits" means "gains, profits or income" and "gains, profits or income" means foreign taxable income. Therefore, "accumulated profits" means foreign taxable income, not income recomputed as if the foreign corporation had been a U.S. taxpayer.

H. The line of decisions with respect to the section 902 credit hold or suggest that "accumulated profits" relates to the foreign tax base.

In examining the cases it is important to distinguish cases dealing with aggregate "earnings and profits" — essentially the corporate surplus available for the payment of dividends — from those dealing with the "accumulated profits in excess of tax," the term used in sourcing the dividend. The first determines whether a distribution represents taxable income to the recipient or a return of capital. That is a U.S. tax question, involving as it does the taxability of an amount received by a U.S. taxpayer. The second involves the attempt to determine what foreign tax was imposed with respect to what income, which is the problem in this case — the problem of sourcing.

1. ***United Dyewood Corp. v. Bowers.*** This case clearly demonstrates that in the 1918 Act "taxable income" meant the foreign tax base. The Second Circuit said, ". . . the words, 'the total taxable income . . . upon . . . which such taxes were paid,' mean the sum used by the foreign government as a base to compute the foreign tax." *United Dyewood Corp. v. Bowers*, 56 F.2d 603, 603 (2d Cir. 1932).

2. ***American Chicle Co. v. United States.*** This Court's decision in *American Chicle Co. v. United States*, 316 U.S. 450 (1942), equates "accumulated profits" with "taxable profits" and with "taxable income" in the Revenue Act of 1918 and fairly clearly implies that the term refers to the foreign tax base. While the statement may not have been critical to the *American Chicle* decision, which did not involve sourcing, it seems to have been carefully considered by this Court.

3. **The "sourcing" cases.** Only three other cases bear, to a greater or lesser degree, on the determination of the numbers to be used in the formula TD/P: *Pacific Gamble Robinson Co. v. United States*, 62-1 U.S.T.C. ¶ 9160 (W.D. Wash. 1961) (not officially reported); *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53 (1972), *aff'd mem.*, 500 F.2d 1399 (3d Cir. 1974); and *Champion International Corp. v. Commissioner*, 81 T.C. 424 (1983), *acq.* 1984-2 C.B. 1, *acq. partly withdrawn* Rev. Rul. 87-72, 1987-2 C.B. 170.

Pacific Gamble Robinson Co. v. United States is contrary to the position of Goodyear, but in *Champion International Corp. v. Commissioner* the Tax Court specifically refused to follow it. 81 T.C. at 443 n.29.

H.H. Robertson Co. v. Commissioner involved *both* the section 312 problem of inclusion of a dividend in the parent's income and the section 902 problem of sourcing. The court began its discussion of the sourcing issue by pointing out that:

> [T]he term "accumulated profits" as used in section 902 refers to a concept *that is quite different from, although related to*, the meaning of the more familiar and widely used term "earnings and profits." [59 T.C. at 75] [Emphasis supplied]

In *Champion International Corp. v. Commissioner* the taxpayer's Canadian subsidiary had had a net operating loss for 1970, which under Canadian law was allowable as a deduction for 1969, producing a refund for that year. Under U.S. law a loss in 1970 would have been allowed as a deduction in 1968. The Government recognized the refund as reducing T in the formula for 1969 and the loss as reducing the amount available as a dividend for that year (D in the formula) but refused to recognize the loss as reducing the accumulated profits after tax (P in the formula). The Tax Court made clear the distinction between "earnings and profits" as the significant number in determining whether a distribution is a dividend and "accumulated profits," which is the significant number in solving the "sourcing" problem. 81 T.C. at 431-32.

The court went on to hold that the loss must be applied in determining *both* P and D, thus following the Canadian computation, saying:

> The purpose of U.S. tax principles in the context of section 902 is to establish a correlation

between the foreign taxes paid on the foreign subsidiary's accumulated profits of a particular year and the dividends paid from the same year's accumulated profits. *To ignore the fact that foreign law computes the tax liability by allowing for loss carrybacks is to assure that this correlation will be lost.*

Petitioner's resolution of this problem does not conflict in any fundamental way with U.S. earnings and profits criteria; it merely reconciles those criteria with the principle that "it is necessary to relate the tax credit to the particular year or years in which the accumulated profits (from which the dividends were paid) were earned and taxed." *General Foods Corp. v. Commissioner*, 4 T.C. at 216. That reconciliation is then applied consistently throughout the section 902(a)(1) computation, in the denominator as well as in the numerator of the fraction. Only in this way can the purpose of the section 901 credit be achieved and the language of section 902(a)(1) followed. [81 T.C. at 440] [Emphasis supplied]

On the Commissioner's alternative argument, which would have applied the loss *neither* to the numerator nor the denominator (the result the Government urges in the present case), the Court added:

> In suggesting that the foreign taxes be reduced to reflect the refund occasioned by the carryback, while the dividends and accumulated profits remain unaffected by the carryback, respondent has proposed a formula whose terms do not stand in the coherent relationship provided for in the statute. The foreign taxes under that formula are not those which were paid "on or with respect to such accumulated profits," *because the taxes have been changed to reflect the carryback while the accumulated profits have not.* [81 T.C. at 443] [Emphasis supplied]

This is Goodyear's complaint exactly. Here, too, the taxes for 1970 and 1971 "have been changed to reflect the carrybacks while the accumulated profits have not."

In discussing the Government's argument in *Champion*, the Tax Court said:

> Respondent frankly admits that his position "will under some limited circumstances result in double taxation," the avoidance of which, he concedes, is the "fundamental purpose of the foreign tax credit provisions." [81 T.C. at 436 n.19]

4. The section 312 cases are not relevant to this issue. Cases involving the amount to be included in the income of the parent (the section 312 problem) include such cases as *Steel Improvement & Forge Co. v. Commissioner*, 36 T.C. 265 (1961), *rev'd*, 314 F.2d 96 (6th Cir. 1963), and *Untermeyer v. Commissioner*, 24 B.T.A. 906 (1931), *aff'd*, 59 F.2d 1004 (2d Cir.), *cert. denied*, 287 U.S. 647 (1932). Neither case involved the present problem. Both dealt with "earnings and profits."

It is essential to recognize that these cases, like section 312 and the other statutory provisions discussed above, are concerned with the amount to be included in the income of the *domestic* taxpayer. They do not deal with sourcing, which is the problem of pairing the income of the foreign subsidiary with the tax imposed on it.

I. The Code provisions that require application of U.S. rules expressly so specify, and deal exclusively with the inclusion of income of foreign subsidiaries in the income of U.S. corporate taxpayers.

In various situations in which income of a foreign taxpayer is included *as such* in the income of a U.S. taxpayer, U.S. rules are *specifically* invoked. The following sections of the Code require the direct inclusion of foreign income in the taxable income of a domestic taxpayer. All of them, as would be expected, provide that United States rules apply to the computation of the

income of the U.S. taxpayer notwithstanding the fact that it was earned in a foreign country:

Section 555 (foreign personal holding company income);

Sections 951 and 964 (subpart F income);

Section 1246 (gain on sale of stock in foreign investment company); and

Section 1248 (sales or exchanges of stock in a foreign corporation).

But the problem of "sourcing" a dividend from a foreign corporation is not a matter of determining the amount of income included by a United States taxpayer. Sourcing is governed by section 902, which in contrast to the above section *has no provision* calling for the application of United States rules, instead defining "accumulated profits" in terms of the foreign income tax base. And it should be noted that even in the sections above the reference (except in section 1248) is to "income" by U.S. rules, not to "earnings and profits."

II. The Government's argument.

A. The Government's argument that "accumulated profits" is an aggregate term would result in judgment for Goodyear.

If the formula for determining the foreign tax deemed paid is applied using the aggregate past taxes paid by Goodyear England and the aggregate profits of prior years as T and P, respectively, it will result in the allowance of most of Goodyear's refund claim. *See* discussion *supra* pp. 6-7.

B. The argument that recomputing the foreign gains, profits and income on which the foreign tax was imposed as if the foreign corporation were a U.S. taxpayer is more likely to produce a correct foreign tax credit is demonstrably contrary to fact.

This argument has been mentioned above and its error demonstrated by examples such as Example 2 at pages 21-22. If a dividend in an agreed amount is sourced to the years when the British taxed the profit from which it was paid, it will be paired with British taxes; if it is sourced anywhere else, it will not be paired with the British taxes, some of which may never be credited.

In Goodyear's case real dividends have been charged against income constructed in several years by the Government when no such income was recognized and taxed by the British. Yet the amount of such dividends reduces the "earnings and profits" available for future dividends. When the "earnings and profits" are thus eliminated, future distributions will not be dividends and no credit will be allowed for taxes actually paid. *Any* such readjustment of foreign gains, profits and income results in distortion that reduces or eliminates the credit properly allowable.

On the other hand it is clear that Goodyear's view can in no event result in tax credits in excess of the total taxes not yet so credited or otherwise recovered.

C. The examples in the Government's brief use artificially distorted numbers and in fact disprove what they seek to prove.

Goodyear's argument and that of the Court of Appeals opinion have rested on the necessity for consistency between foreign tax and the foreign tax base in computing the credit. It is respectfully submitted that the examples worked out in Goodyear's brief prove the point, and we have challenged the Government to produce similar examples to support its side. It has not seen fit to do so. It has set forth on pages 21 and 22 and again on page 31 of its brief what purports to be an example but has not set out the figures in any kind of schedule. It may be helpful to show the assumed numbers in the three cases set out (all except the apparent foreign tax rate being from the Government brief) as follows:

	U.S. Rules	Foreign Rules
Case 1		
Earnings	100	100
Foreign tax	20	20
Apparent foreign tax rate		20%
Case 2		
Earnings	100	180
Foreign tax	20	20
Apparent foreign tax rate		11.11%
Case 3		
Earnings	100	60
Foreign tax	20	20
Apparent foreign tax rate		33.33%

The Government then argues that using the foreign tax base as the measure of accumulated profits produces "eccentric results." If we allow as a premise that the British compute their tax by applying their rate to *U.S. income* then of course the British tax will bear no consistent relationship to the British tax base. But that assumption is contrary to fact. The British tax is computed by applying the British rate to the British tax base and is necessarily consistent with it. This example proves only that if eccentric data are fed into a formula, it will produce eccentric results.

If the Government had seen fit to use a *constant* foreign rate of tax in its example and to lay out for the Court's examination comparative schedules, as Goodyear has done, showing the differing results reached by application of U.S. rules as opposed to following the foreign determination, the examples would inevitably demonstrate the same conclusion reached by Goodyear in its similar examples. That conclusion is that since the foreign tax represents the foreign tax rate applied to the foreign tax base, any attempt to substitute for the foreign tax base in the denominator an amount based on income redetermined according to U.S. law will distort the credit and defeat the statutory purpose.

D. The argument that sections 902 and 316 together prove that "accumulated profits" and "earnings and profits" are the same thing is based on incomplete quotation of the law.

This point has been discussed at pages 27-28 of the present brief. All dividends are distributed out of earnings and profits. *Not* all dividends are paid out of accumulated profits. But, *to the extent* that they are, they are sourced to the accumulated profits of each year as determined by the foreign taxing authority to determine the foreign tax "appropriate" to them.

In any event, as demonstrated above at page 5, the stipulated issue here is between foreign "gains, profits and income" and "taxable income" under U.S. rules; "earnings and profits" are not the issue, and have not been set out in the Stipulation at all.

E. The decision below did not overturn any established administrative practice.

In attributing such an effect to the decision, the Government relies on these rulings:

I.T. 2676, XII-1 C.B. 48 (1933). The language quoted by the Government at page 32 of its brief merely requires that all income be included in the tax credit computation, whether or not the income is taxed by the foreign country, but it does not say that computations such as the amount and timing of income, depreciation, and inventory adjustments are to be taken into account as if U.S. rules applied; in fact the ruling talks about the "distributable income or surplus" of the foreign corporation, and suggests, if anything, a corporate surplus such as British accountants would determine. The ruling clearly fails to establish a practice of applying U.S. tax principles in "sourcing" a dividend. In fact the principles of sourcing and grossing up were not established for another ten years.

In any event, this ruling was declared obsolete by Rev. Rul. 70-293, 1970-1 C.B. 282.

Rev. Rul. 63-6, 1963-1 C.B. 126. This ruling does indeed assert that U.S. rules should govern the determination of "accumulated profits." But in 1972 the Commissioner declared this ruling too to be obsolete. Rev. Rul. 72-621, 1972-2 C.B. 651.

Rev. Rul. 87-72, 1987-2 C.B. 170. This ruling partially withdrew the Commissioner's announced acquiescence in the *Champion* case, which essentially supports Goodyear's argument. In 1984 the Commissioner had announced his general acquiescence in *Champion*. But in September 1985 Goodyear filed the present action in the Claims Court, and in April 1987 it filed its Motion for Summary Judgment. Then on August 3, 1987 the Commissioner issued Rev. Rul. 87-72, which appears to be an attempt to limit his acquiescence in *Champion* so as to leave room for his contrary position in the present case. This action by the Commissioner merely confirms the fact that the *Champion* case really supports Goodyear.

Rev. Rul. 87-14, 1987-1 C.B. 181. This ruling, issued while the present case was pending (and after the Tax Reform Act of 1986 had eliminated "sourcing" for future years), is similarly self-serving.

One point does seem clear: the Commissioner's position when he withdrew his 1963 ruling and when he acquiesced in the *Champion* case was contrary to his later position when he issued Rev. Rul. 87-72 and withdrew the acquiescence in *Champion*. Moreover, one other ruling, Rev. Rul. 74-310, 1974-2 C.B. 205, is inconsistent with the rulings cited above because it holds that:

> the amount of foreign income tax paid by a domestic corporation's wholly owned subsidiary that uses the completed contract method of accounting for Federal income tax purposes but uses the percentage of completion method for foreign income tax purposes is determined by foreign standards.

The text of the ruling quoted the very definition of "accumulated profits" in Reg. § 1.902-3(c)(4) on which Goodyear relies.

Although the Government asserts that the Commissioner's position is fifty years old, the whole concept of sourcing was not established until the *General Foods* case in 1944. The language of the Regulations under Section 902 on which the Government relies was not a part of the Regulations until 1965. Furthermore, the Government's quotation on page 33 of its brief from Treas. Reg. § 1.902-3(c) is not quite complete. The omitted portion goes on to say:

> Since . . . *the accumulated profits*, determined in accordance with subparagraph (1) of this paragraph, for the taxable year *are always equal to the total amount of the gains, profits, and income for such year*, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. [Treas. Reg. § 1.902-3(c)(4)] [Emphasis supplied]

Thus in 1965, *only five years* before the first dividend involved in the present case, a new Regulation essentially supported Goodyear's position. This language still appears in the Regulation. This is hardly fifty years of consistency.

Finally, perhaps it is not unfair to point out that in the present case a similar net operating loss of the very same British subsidiary for 1972 was allowed by the Internal Revenue Service in computing the Respondent's foreign tax credit in this case. *See supra* note 3.

III. The opinion of the Claims Court.

While some aspects of the opinion of the Claims Court have already been discussed, some further points should be mentioned here.

A. Factual misconceptions.

1. Referring to the 1970 and 1971 dividends, the Claims Court incorrectly stated (Cert. App. at 10a) that Goodyear claimed credit for British tax deemed paid *on*

the dividends. Britain did impose a tax on those dividends and the credit claimed for *that* tax was allowed as a *direct* tax credit. That tax is not involved in the present case. The credit claimed here is for the British tax imposed on the profits of Goodyear England for 1968, 1969, 1970 and 1971, *out of which* the 1970 and 1971 dividends were paid (Ex. I, J.A. at 30).

2. The Claims Court said the 1972 loss was "recognized under both United States and British tax law." This is not the fact and does not appear in the Stipulation. Exhibits I and J (J.A. at 30-31) show that the income for 1971 *after* the 1972 carryback was £1,648,254. The British tax return for 1971 (Exhibit P, J.A. at 46-49) shows that the income reported thereon of £1,648,254 was the result of subtracting the 1972 loss from the income as computed for British purposes. The 1972 loss, as shown on Exhibit P, was £1,397,828, which is the same amount shown on the British return as filed for 1972 (Exhibit Q, J.A. at 50-53). In its recitation of the facts of the case, the Claims Court implied that the circumstances giving rise to the deduction in 1973 were different from those giving rise to the 1972 deduction. *See* Cert. App. at 10a-11a. The court's statement is not in accordance with the Stipulation.

3. The Claims Court said that "Both parties in the present case agree that United States tax law governs the definition of the numerator, that is, whether a distribution of property by a foreign subsidiary to a domestic parent corporation is a dividend or a return of capital." Cert. App. at 20a-21a. Goodyear did not agree with that sentence. Goodyear does agree, although it is not at issue here, that whether a distribution of property by a foreign subsidiary to a domestic parent corporation is a dividend or a return of capital for U.S. income purposes is governed by U.S. law. That is what the *Steel Improvement & Forge* case was about. But to turn that statement into a statement that U.S. tax law governs the definition of the numerator in the section 902 fraction is

to demonstrate the complete misunderstanding under which the Claims Court was laboring.

4. The Claims Court said, "The parties have stipulated that all adjustments made by the Commissioner were proper under United States tax law and that the two British deductions which resulted in the 1973 loss were not allowable deductions under United States tax law." Cert. App. at 24a. This is not in the Stipulation. Goodyear agreed in paragraph 9 of the Stipulation (J.A. at 22-23) that the deductions in question would not have been allowed if Goodyear England had been a U.S. corporation. But it was *not* a U.S. corporation and was *not* subject to U.S. tax. It filed its return in England, which allowed the deductions in computing the foreign taxes in question.

B. Tax avoidance charge.

The Claims Court apparently thought Goodyear was asserting a claim for credit for taxes that had been refunded and accused Goodyear of attempting to "eviscerate the very purpose of the pro-rata credit and permit plaintiff a substantial windfall in avoiding other taxes with the phantom taxes deemed paid." Cert. App. at 24a.

If this were a fair description of Goodyear's argument, the pejorative language might be deserved. But the Claims Court apparently failed altogether to grasp the concept of "sourcing." Goodyear is not asserting a claim to the 1970 and 1971 taxes that were refunded. Goodyear is claiming that because there was a loss in 1973 which carried back to 1971 and to 1970, accumulated profits for those years were reduced or eliminated, and it was this event that produced the refund. There being no accumulated profits in 1971 and an insufficient amount in 1970, some of the dividends must be sourced to 1969 and 1970, and it is the taxes paid to Britain for *those* years which are claimed as credits. They are most certainly *not* "phantom taxes."

C. "Gains, profits and income."

The Claims Court clearly said that:

The relation of "*gains, profits and income*" *to foreign income taxes indicates this tax concept is to be equated with foreign taxable income.* [Cert. App. at 26a] [Emphasis supplied]

That court also quoted the provision of section 902(c)(1)(A) defining "accumulated profits" as equal to "gains, profits or income." Cert. App. at 19a-20a. It would seem to follow that "accumulated profits" equals foreign taxable income. Then how can we explain the Claims Court's assertion that the denominator of the fraction, which is "accumulated profits," means U.S. income?

We think the answer is that the Claims Court mistakenly thought the parties had agreed that U.S. law governed the numerator; thus it was forced to hold that algebraic consistency required that the denominator be determined under U.S. law, notwithstanding its analysis above, which seems to lead to the opposite conclusion. But the parties did not so agree.

Actually in the present case the dividends were in cash, which has the same value in either country. On the other hand T — the tax — is part of the numerator, and the tax is necessarily determined under British law. Algebraic consistency would therefore require that the denominator be computed the same way. And that way, not coincidentally, corresponds not only with the words of the statute but with its purpose of producing a result harmonious with the direct tax credit and with common sense.

In view of these clear errors on the face of the Claims Court's opinion, it should be evident that the Court of Appeals had no choice but to reverse its judgment.

IV. Policy considerations.

Even if it had not appeared quite so clearly that the Court of Appeals was correct in its understanding of the law, this Court should resolve any doubts in favor of Goodyear for the following reasons:

A. Goodyear's computation necessarily produces a fairer result.

Since it is clear that in no event may there be a credit for more foreign tax paid than was actually paid and not recovered as a credit or as a refund, it must follow that the computation that produces the greater credit must necessarily approach most closely the result applicable to a branch operation, which always produces a full recovery, subject only to the limits of section 904.

B. Attempting to redetermine income of foreign corporations as if they were U.S. taxpayers will create endless administrative problems.

In its petition for certiorari, the Government argued that a decision for Goodyear would impose an unreasonable administrative burden on the Internal Revenue Service. The contrary is true. A decision for the Government will greatly burden both the Internal Revenue Service and corporate taxpayers seeking to obtain the credit in a number of ways. For example:

1. Will the U.S. agent make an audit of the foreign corporation to determine whether its foreign return satisfies U.S. rules?

2. Can the U.S. agent second-guess the foreign agent on whether items claimed as repair expense should be capitalized?

3. Will charitable contributions by foreign corporations have to satisfy U.S. standards by having foreign charitable donees qualify under section 501(c)(3), as is required in the U.S.?

4. Will the U.S. agent, applying U.S. rules, require that contributions to pension and profit sharing plans be

made to plans qualified under the U.S. Internal Revenue Code?

5. What about inventory pricing rules? That issue is actually present in the case at bar. And the Internal Revenue Service decided in 1982 to begin requiring foreign corporations to apply to it for permission to adopt the "Last-in-First-out" method of pricing inventories. Private Letter Ruling 8313083 (Dec. 28, 1982). Less than a year and a half later, perhaps recognizing the anomaly of attempting to regulate the accounting practices of a corporation which was not a U.S. taxpayer at all, the Internal Revenue Service amended its ruling to require that the U.S. corporate shareholder claiming the foreign tax credit should apply to the Internal Revenue Service for permission to have the foreign corporation use the changed accounting method to compute the credit under section 902. Private Letter Ruling 8435119 (May 31, 1984). It did not allude to the possibility that the foreign corporation might have more than one U.S. corporate shareholder qualifying for the section 902 credit nor to the rule of Treas. Reg. § 1.472-1 that LIFO accounting may be elected for tax purposes only if it is also regularly employed for corporate accounting purposes.

6. How will these adjustments be contested? The foreign corporation cannot do so because its own taxes are not at issue; it cannot appear as a party to a suit in a U.S. court on these matters.

7. Section 902 allows the indirect credit to any corporation owning 10% or more of a foreign corporation. Can each of them contest all of these issues separately?

8. The fact is that those who drafted the foreign tax credit provisions apparently did not contemplate that there would be any such issues to contest. Section 905 provides that in the case of a refund of a foreign tax (as in the present case) the credit allowed the U.S. corporation shall be redetermined *and assessed*. There is no

provision for a statutory Notice of Deficiency under section 6212, which is the condition precedent to filing a case in the Tax Court, and none was issued in the present case. Obviously no provision for appeal to the Tax Court was thought necessary because no disputes were anticipated. If the Government is correct, Congress will have to establish procedures for resolving the anticipated disputes.

All these issues and more — in fact everything that can give rise to litigation under Internal Revenue Code provisions applicable to U.S. corporate taxpayers — can be reaudited if U.S. law is to be applied. Yet none of this actually affects the income tax liability of the foreign corporation to its government or to ours. It bears only on the sourcing of the profits to various years so as to determine what tax was paid in an earlier year that can be allocated to a dividend. In most years it obviously will not even matter, but the audit must be made to find out whether it does matter. Minds will be boggled that have never been boggled before. And all this for a statute that was repealed in 1986!

CONCLUSION

Neither the language nor the purpose of section 902 of the Code will be served unless the deemed paid foreign tax credit to which Goodyear is entitled is computed in a manner which relates the foreign taxes to the accumulated profits on which the taxes were imposed and from which the dividend from Goodyear England to its U.S. parent was paid. This can be accomplished only if this Court rules that it is proper to reduce Goodyear England's accumulated profits for 1970 and 1971 to reflect the application of the foreign net operating loss carryback that gave rise to the refunds.

Goodyear respectfully requests that the judgment of the Court of Appeals be affirmed.

Respectfully submitted,

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APPENDIX

The Treasury Regulations, as in effect in 1970 and 1971, provided in pertinent part:

§ 1.902-3. Credit for domestic corporate shareholder of a foreign corporation (after amendment by Revenue Act of 1962).

* * * * *

(c) *Determination of accumulated profits and taxes paid on or with respect thereto.*

* * * * *

(4) *Taxes paid on or with respect to accumulated profits of a foreign corporation.* For purposes of this section, the amount of foreign income taxes paid or accrued on or with respect to the accumulated profits of a first-tier corporation or second-tier corporation, as the case may be, for any taxable year shall be so much of the foreign income taxes for such year as is properly attributable to such accumulated profits. For such purpose, the foreign income taxes which are properly attributable to the accumulated profits for any taxable year shall be the same proportion of the foreign income taxes imposed on or with respect to the gains, profits, and income for the taxable year as the accumulated profits, as determined under the applicable provision of this paragraph, bear to the total amount of such gains, profits, and income. Since, in applying the preceding sentence to a first-tier corporation which is not a less developed country corporation for the taxable year (and to a second-tier corporation to which subparagraph (3)(i) of this paragraph applies), the accumulated profits, determined in accordance with subparagraph (1) of this paragraph, for the taxable year are always equal to the total amount of the gains, profits, and income for such year, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. For purposes

of this subparagraph, the gains, profits, and income of a foreign corporation for any taxable year shall be determined after reduction by any income, war profits, or excess profits taxes imposed on or with respect to such gains, profits, and income by the United States.

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No. 88-1474

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

THE GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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21pp.

TABLE OF AUTHORITIES

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1. Respondent mistakenly asserts (Br. 5-7) that the government in its opening brief has taken "new position[s]" for the first time in this Court. There is manifestly no substance to respondent's suggestion (Br. 6-7, 16, 38) that the government has argued that "accumulated profits" in this case should be computed on an aggregate basis, as under the 1986 legislation, rather than on an annual basis. In our opening brief (at 4 n.4, 17 n.6, 25 n.11), we repeatedly note that the Section 902 credit for the years at issue is computed on an annualized basis and that the dividends must be "sourced" to the profits of the years out of which they are paid. We also explain (Br. 7 n.5) that the difference between respondent's and the government's calculation of tax liability is caused in large part by a dispute over whether the dividend in question can be "sourced" to respondent's relatively high foreign tax years of 1968 and 1969. We do, however, question

respondent's statement (Br. 16) that the concept of "sourcing" is "critical" to the resolution of this case; it is actually quite secondary to the question presented. The critical question here is whether the term "accumulated profits" in Section 902 of the Internal Revenue Code (26 U.S.C.)—*i.e.*, the profits to which the dividends are "sourced"—is determined in accordance with principles of U.S. law or of foreign law. Once that determination is made, the "sourcing" calculation and the application of the Section 902 apportionment formula follow as a matter of course.

There is likewise no merit to respondent's assertion (Br. 5) that, in stating that "accumulated profits" should be computed according to the principles governing the determination of "earnings and profits" under U.S. law, the government is arguing for a different definition from that reflected in the stipulation. As respondent states (Br. 5), the language used in the stipulation was "computed under United States income tax concepts," and this phrase clearly encompasses the concept of "earnings and profits." Nothing in the stipulation suggests an intent not to invoke that concept, which is the one explicitly identified in the relevant regulation (Treas. Reg. § 1.902-3(c) (1971 ed.)) and understood by the commentators (see, *e.g.*, E. Owens, *The Foreign Tax Credit* 121-122 (1961)), by the Tax Court (*H.H. Robertson Co.* v. *Commissioner*, 59 T.C. 53, 78-79 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974)), and by Congress (see U.S. Br. 39 n.17) to be the benchmark for defining "accumulated profits."[1]

2. Conspicuously absent from respondent's submission is any analysis of the congressional purpose in establishing the allocation formula of Section 902. Respondent merely states that the purpose of the foreign tax credit in general is to prevent

[1] As we noted in our opening brief (at 25 n.11), the concepts of "accumulated profits" and "earnings and profits" are not identical because the former are computed on a year-by-year basis. Hence, there is no force to respondent's reliance (Br. 27-28) on the failure of Section 902 to use the term "earnings and profits" or on the fact that the statute uses the phrase "to the extent * * * dividends are paid * * * out of accumulated profits." See, *e.g.*, *H.H. Robertson Co.* v. *Commissioner*, 59 T.C at 78-79, 86-87.

double taxation, and respondent also notes that the indirect credit is intended to equate the treatment of subsidiary operations with that of branch operations—in the limited sense that the domestic owner of a branch always receives full credit for the foreign tax in the year paid. See Resp. Br. 7, 11-13, 20. This incomplete view of Section 902 conveniently leads to the conclusion that the allocation formula is to be interpreted so as to maximize the allowable credit; in respondent's words, "the computation that produces the greater credit must necessarily approach most closely the result applicable to a branch operation" (Resp. Br. 47).

Obviously, respondent's limited view of the purpose of Section 902 is mistaken. If Congress wanted to advance the goal of maximizing the credit (because branch operations get the full credit in the year the tax is paid), it could simply have allowed the parent of a foreign subsidiary to take the full credit. There would be no need for the apportionment formula of Section 902 at all. But there is a need for apportionment, and respondent completely ignores its basic function—namely, to prorate the foreign tax deemed paid *when the subsidiary distributes less than all of its earnings to the U.S. parent*. Congress realized that when a subsidiary does not distribute all of its earnings to its parent, the parent is not currently taxed on those earnings and should not be entitled to a credit for all of the foreign tax paid. In that situation, in sharp contrast to the branch operation, the parent has not received all of the earnings subjected to the foreign tax; some of those earnings have been retained by the foreign subsidiary and thereby insulated from U.S. tax. Thus, as we explained in detail in our opening brief (at 26-28 & n.12), the purpose of Section 902 is to guard not only against double taxation, but also against *undertaxation*. In cases of partial distributions, Congress determined that equal treatment of branch and subsidiary operations would be achieved if the parent could take a partial credit; if no credit were allowed, the parent would be subjected to double taxation, but if the full credit were allowed, there would be undertaxation and the subsidiary operation would receive preferential treatment as compared to the branch operation. The allocation formula of Sec-

tion 902 is designed to allow a prorated credit that bears the same proportional relationship to the total foreign tax paid as the dividend distribution bears to the total earnings.

Respondent seeks to have subsidiary operations treated the same as branch operations with respect to the amount of the credit received, without focusing on whether the two operations are reporting an equivalent amount of income. But it is critical to the goal of nondiscrimination to consider the income that is distributed to the U.S. parent. In the case of a branch operation, all of the earnings are immediately received by the parent and subjected to U.S. taxation. In the case of a subsidiary operation, like respondent's, the profits earned by the foreign subsidiary are generally not included in the income of the U.S. taxpayer until they are distributed as dividends. As this Court has noted, "[s]uch dividends, not its subsidiary's profits, constitute its income to be returned for taxation." *American Chicle Co.* v. *United States*, 316 U.S. 450, 452 (1942). Here, during the years in question, respondent's subsidiary did not distribute all of the earnings that could have been distributed as dividends; rather, it retained a substantial portion of those earnings as surplus. Respondent's approach to the apportionment formula essentially ignores these retained earnings (to the extent they exceed the income recognized under foreign law) or pretends that they have been distributed (see U.S. Br. 45-46), thus allowing respondent both to receive credit for all of the foreign tax paid by the subsidiary and also to have its subsidiary retain earnings immune from U.S. taxation. That approach would give the subsidiary operation a decided advantage over a branch operation in derogation of Congress's clear purpose in enacting Section 902. See also point 7, *infra*.

3. Respondent's mistake in focusing solely on the credit received in a branch operation, but not on the income subjected to U.S. tax, leads it to a fallacious premise that seriously undermines its argument. Respondent states (Br. 12) that a 40% British tax rate is the "touchstone" for determining whether its tax credit is "consistent" with that of a branch operation. Respondent then proceeds to argue (*id.* at 25-27) that the

government's approach to Section 902 must be incorrect because it yields an effective British tax rate significantly lower than 40%. Respondent confuses the "actual" foreign tax rate with the "effective" foreign tax rate applied to U.S. income. In fact, when income computed under British law differs from that computed under U.S. law, the *effective* British tax rate on U.S. income will never equal 40%, and the divergence from the actual rate identified by respondent is precisely what should be expected if the Section 902 credit is properly serving its function of promoting equal treatment of branch and subsidiary operations.

The British tax is laid at 40% on income *as computed by Britain*; it necessarily follows that, in cases where the U.S. definition of income differs from that of Britain, the British tax will not be 40% of the U.S. income. Clearly, it is the effective rate imposed on U.S. income that is significant to the taxation of a branch operation. Foreign concepts of taxable income are irrelevant in determining how much of the earnings of a foreign branch constitute income to its domestic owner; those earnings flow directly to the owner and are included in its income under U.S. tax principles. Thus, if the income of the branch is higher under United States law than under British law, the foreign tax imposed at 40% on the foreign tax base necessarily will be less than 40% of the larger sum that the owner must report as income on its United States return. And, consequently, the direct tax credit available to the owner of the branch will also be less than 40% of the income.[2] It is this "effective" rate of foreign

[2] For example, suppose the United States does not allow a $40 deduction that is allowed by Britain and therefore the income of the branch is defined as $100 under United States law but as $60 under British law. The British tax will be $24 ($60 x 40%), and the owner of the branch will be entitled to a direct foreign tax credit in that amount. This credit is only 24% of the income of the branch that is subject to United States taxation. The converse is also true – if the profits of the branch are lower under United States law than under British law, the foreign tax will be greater than 40% of the profits that constitute income to the domestic owner (although Section 904 prevents the owner from taking a credit that exceeds the U.S. income tax attributable to the income from the foreign country (see Resp. Br. 20)).

tax, *i.e.*, the foreign tax paid expressed as a percentage of the branch's income computed under United States law, that is relevant in measuring whether the Section 902 tax credit for a domestic company with a British subsidiary is essentially equivalent to that available to a domestic company with a branch.[3]

Contrary to respondent's contention, examining the effective rate of tax on the facts of this case demonstrates the correctness of the government's position. The Section 902 credit that the Commissioner allowed to respondent is entirely consistent with the credit that would have been granted had it been conducting the same business as a branch. If respondent had operated its business through a branch, it would have received a credit for all of the foreign tax paid by the branch, but it also would have been required to include on its U.S. income tax return all of the branch's profits as determined under United States law—the loss and carryback allowed only by Britain could not have been used to offset those profits. The result in 1970 and 1971 would have been a relatively small British tax (and therefore tax credit)

[3] This divergence of the "effective tax rate" from the stated foreign tax rate is a well recognized phenomenon. See, *e.g.*, 1 E. Owens & G. Ball, *The Indirect Credit* 169-170 (1975). This effective rate is not a "synthetic tax rate in no way related to reality" (Resp. Br. 25); to the contrary, it reflects the true burden of the foreign tax on the earnings reported as income on the U.S. return. Indeed, one of the major reasons for the 1986 change in the computation of the Section 902 credit was to eliminate the ability of multinational corporations to obtain a tax advantage by manipulating their dividend distributions to take advantage of fluctuations in the effective rate. Congress found that many companies sought to maximize the credit by having their foreign subsidiaries accumulate earnings in years when the effective foreign tax rate was low and distribute the earnings in years when it was high, and Congress eliminated the annualization feature of the credit largely to end the use of this "rhythm method," noting that fluctuations in "effective foreign tax rate[s]" created opportunities for tax avoidance. See S. Rep. No. 313, 99th Cong., 2d Sess. 305-306 (1986). We note that Congress's recognition of the widespread use of this "rhythm method," which can be used only if "accumulated profits" are computed in accordance with U.S. concepts of taxation or if the actual foreign tax rate fluctuates, further demonstrates how settled was the interpretation of Section 902 that has been overturned by the court of appeals below.

because of the reduced British tax base, yet a relatively large amount of U.S. income; consequently, the effective British tax rate on the total income of a branch operation would have been quite small. Because respondent operated its business through a subsidiary, its U.S. income for these years includes only the dividends distributed. When the dividends are "sourced" to these years, however, comparability with a branch requires the parent to recognize income according to U.S. concepts, which will yield the same small effective British tax rate that would have occurred in the case of a branch operation. On these facts, computation of "accumulated profits" under U.S. concepts yields an effective tax rate of only 19.9% for 1970 and 1.6% for 1971, which is precisely what respondent would have paid in 1970 and 1971 had it operated as a branch. See Resp. Br. 26; J.A. 31.[4] The reason that the rates for those years were so low is that the generous British loss and carryback allowances virtually eliminated the British tax base for 1971 and substantially reduced it for 1970.

4. As we explain in detail in our opening brief (at 15-25), the apportionment formula of Section 902 is incongruous unless accumulated profits are defined in terms of U.S. principles. When a foreign subsidiary makes a distribution to its domestic parent, the concept of "profits" is relevant at three stages of the Section 902 inquiry. First, the U.S. parent must determine how much of the distribution is a dividend reportable as income on its U.S. return, which requires determining the extent to which it was paid out of "earnings and profits." Second, the amount of

[4] In 1970, a branch operation would have had to recognize £3,812,473 in income, computed under principles of U.S. law. The British tax for that year was £758,437, yielding an effective rate of 19.9%. In 1971, the branch would have recognized U.S. income of £3,224,486 and paid British tax of only £52,567. For that year, the effective tax rate—and therefore the effective rate of the credit—would have been only 1.6%. See J.A. 31. Thus, the figures computed by respondent on page 26 of its brief show that the Section 902 formula works properly when "accumulated profits" are defined in terms of U.S. concepts. Conversely, if the credit is computed on the basis of an effective British tax rate of 40%, it will bear no relation to the credit that would have been available to a branch operation.

"dividends" to be placed in the numerator of the Section 902 fraction must be determined, *i.e.*, the dividends paid out of "accumulated profits." Third, the amount of "accumulated profits" to be placed in the denominator of the fraction must be determined. It is our submission that all of these quantities must be determined in a consistent manner, which means according to U.S. tax principles. The "earnings and profits" relevant to the first determination clearly are determined according to U.S. law pursuant to Sections 312 and 316 of the Internal Revenue Code (26 U.S.C.). If the apportionment formula is to fulfill its purpose, the "dividends" in the numerator of the fraction must correlate with the "dividends" reported on the U.S. tax return, *i.e.*, be based on profits computed under U.S. principles. And, as the Claims Court noted (Pet. App. 21a), "[a]lgebraic consistency" then demands that the profits in the denominator of the fraction also be based on U.S. tax principles.

Respondent agrees with much of this analysis. Respondent agrees that the determination of the amount of dividends reported on the parent's U.S. return must be based upon profits computed under U.S. tax principles (see Resp. Br. 37, 44; see also National Foreign Trade Council Amicus Br. 29). Respondent also appears to agree that "algebraic consistency" demands that accumulated profits in the numerator be determined according to the same principles as in the denominator (see Br. 46). Respondent diverges from the above analysis, however, in insisting (Br. 44) that U.S. law does not govern the definition of the numerator. Although respondent does not explicitly state what does govern the definition of "dividends" in the numerator, presumably its position is that they are distributions made out of profits as determined by foreign law. This position is untenable.

The ultimate goal of Section 902 is to determine the appropriate tax credit that should be allowed on the parent's U.S. return to reflect the foreign tax that is "deemed paid" on the dividend income reported on that return. In the words of the statute, the foreign tax shall be allowed as a credit in "the same proportion" as the "amount of such dividends * * * bears to the amount of such accumulated profits" (§ 902(a)(1)). Clearly, the

dividends in the fraction must correlate with the dividends reported on the U.S. return in order to obtain the correct proportion for allowing a partial credit against the U.S. income tax on those dividends. As this Court explained in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942), the foreign tax is to be "proportioned to the dividends made available to the parent in this country" (*id.* at 454), which means that "the numerator is the dividends received by the parent" (*id.* at 452). If the dividends in the ratio do not correlate with the dividends being taxed on the parent's return, then the apportionment exercise becomes meaningless.[5] See generally E. Owens, *The Foreign Tax Credit* 121-122 (1961). Thus, as the Tax Court has held on several occasions (see U.S. Br. 19-20), the "dividends" in the numerator of the Section 902 fraction must be determined on the basis of profits computed under U.S. concepts.[6] If so, the principle of "algebraic consistency" recognized by respondent demands that the term "accumulated profits" in the denominator

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[5] For example, suppose a subsidiary pays $80 in British tax on income computed as $200 under British law and as $1000 under U.S. law. If the subsidiary distributes 50% of its after-tax earnings and profits to the parent ($460), one would expect Section 902 to allow the parent to take 50% of the foreign tax ($40) as a credit on its return. But under respondent's erroneous definition of "accumulated profits," the numerator of the fraction – the "dividends" paid out of "accumulated profits" – would be only $120 (the after-tax earnings of the subsidiary according to foreign law principles). A ratio containing this figure cannot be expected to yield the correct proportional credit to be applied against the tax on the $460 dividend; in this example, respondent's approach would allow the parent to take the full $80 credit on this 50% distribution ($80 × $120/($200 – $80) = $80).

[6] Respondent seeks to blunt this argument by asserting that the amount of foreign taxes paid "is part of the numerator" (Br. 46), and therefore the denominator must also be determined in accordance with foreign tax principles. This assertion is incorrect. The Section 902 fraction measures the ratio of dividends to after-tax profits. The amount of foreign taxes paid simply represents the maximum credit, to which this ratio is applied to determine the proportional credit. In mathematical terms, the amount of tax paid is the "multiplicand" (*American Chicle Co.* v. *United States*, 316 U.S. at 452), not part of the fraction, and there is no logical reason why the derivation of the amounts in the ratio should be affected by the manner in which the tax is computed.

must also be defined under U.S. concepts, and therefore the decision below cannot stand.

5. Respondent relies heavily (Br. 20-24) on two examples (numbered 2 and 3), which it claims illustrate the distortions caused by the Commissioner's interpretation of Section 902. Amicus curiae National Foreign Trade Council presents its own examples (Br. 15-17, 21-25), also claiming that they demonstrate the error of the Commissioner's approach. These examples will not bear the weight ascribed to them, however, for they do not illustrate anything about the general operation of the Section 902 credit.

The crucial feature common to all of these examples is hypothesizing a year in which the subsidiary pays foreign tax, but has *zero* profits under U.S. principles. Because a dividend cannot be "sourced" to a year in which there are no accumulated profits, the foreign tax paid in that year can never be matched to a dividend and therefore it can never be credited as "deemed paid." Thus, the narrow point illustrated by the various examples is that defining accumulated profits in terms of U.S. concepts yields an anomalous result in one specific situation: where foreign tax is paid in a year in which the subsidiary's accumulated profits under U.S. concepts are zero, the credit for the foreign tax paid in that year will be "blocked," resulting in some degree of double taxation after a full dividend distribution. The examples, however, illustrate nothing about a case in which there is not a zero year; so long as there exists even one dollar in after-tax profits under U.S. concepts, the anomalous result highlighted by respondent will disappear because the Section 902 formula will credit the foreign tax paid in that year in full when a dividend distribution is "sourced" to the U.S. profits for that year.

These examples provide no basis for affirmance of the judgment below. First, respondent's assertion (Br. 22) that one of the examples "presents the very essence of Goodyear's case" is insupportable. The theoretical possibility of an unrecoverable payment of foreign tax is not present in most cases, and it certainly is not present here. The accumulated profits of respondent's subsidiary for 1970 and 1971, as computed by the Com-

missioner under U.S. law, are far in excess of zero. The Commissioner's computation already credited respondent with a portion of the foreign taxes paid for those years (based on the ratio of the dividends paid to the accumulated profits), and the rest of those taxes, as well as the foreign taxes paid in 1968 and 1969 whose credit respondent seeks to accelerate, remain fully accessible to be claimed as credits whenever the balance of the retained profits may be distributed. See J.A. 31.[7] Thus, these examples bear no relation to the facts of this case.

In any event, the "zero income" anomaly illustrated by respondent's examples provides no support for the conclusion that accumulated profits should be determined under foreign law principles. At most, the examples show that Section 902 does not work perfectly in a carefully structured set of circumstances that is not likely to occur frequently. If that anomaly is unacceptable, the appropriate way to address it is through a narrowly tailored adjustment, not to misinterpret and eviscerate the statute by defining accumulated profits in terms of foreign law principles. As we have explained, respondent's interpretation would incorrectly apportion the credit, not just in unusual "zero income" cases, but in every case in which profits are different under U.S. and foreign law concepts. Indeed, even with respect to the specific problem of a "blocked" or unrecoverable credit, respondent's interpretation is inferior. If accumulated profits are determined according to foreign law, in every case in which the foreign definition of income yields a larger amount than the U.S. definition, the taxpayer will be restricted from recovering a portion of the foreign tax paid. This is because a distribution in the full amount of the U.S. income will yield only

[7] There is similarly no merit to respondent's effort to analogize this case to one where there is a difference in U.S. and foreign rules regarding the timing of a loss carryback (see Br. 22-23). Example 3, and respondent's references to the timing of a loss, all involve carryback of a loss that is recognized under both foreign and U.S. law, but where the laws of the two countries differ with respect to the timing of the carryback. Here, however, the discrepancy is over the availability of the loss at all. If respondent's profits are computed under U.S. principles, the loss deduction allowed by Britain in 1973 is not available. Instead the subsidiary's loss for 1973 is converted into a profit, and there is no question of carryback at all. See J.A. 24.

a partial credit, and any additional distribution will not be a dividend (because it is not out of "earnings and profits") and therefore will not give rise to any Section 902 credit. See U.S. Br. 22; point 7, *infra*. Thus, although the "zero income" anomaly has long been recognized, it has never been suggested that it should be "cured" by defining accumulated profits in terms of foreign law. See, *e.g.*, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.11, at 17-44, 17-47 (5th ed. 1987); 1 E. Owens & G. Ball, *The Indirect Credit* 164-165, 174 (1975).[8] Clearly, this discrete hypothetical situation, which is not presented here, cannot form the basis for resolving one of the fundamental questions relating to the general applicability of Section 902.

6. Respondent argues that the term "total taxable income" used in the original 1918 version of Section 902 in lieu of "accumulated profits" clearly refers to a foreign definition of income, and therefore the statute at issue here should be construed the same way. See Resp. Br. 30; National Foreign Trade Council Amicus Br. 13-14; Vulcan Materials Co. Amicus Br. 5-11. The premise of this argument is highly questionable.[9] As we have explained, it would have been illogical for Congress to have based the statute's apportionment formula upon a foreign

[8] The "zero income" anomaly has, for the most part, been cured prospectively by the 1986 amendments that eliminate the annualized approach and create a pool of accumulated earnings. See U.S. Br. 38-39 & n.17. One of the reasons for this change identified in the legislative history was to eliminate the "zero income" anomaly that could occur through the application of U.S. carryback rules. See S. Rep. No. 313, *supra*, at 305-306.

[9] Respondent is correct in stating (Br. 30) that there is no affirmative indication that Congress in 1921 sought to change from a foreign definition of income to one based on U.S. tax concepts. But there is also no reason to believe that Congress understood the 1918 statute to refer to foreign law concepts. We would add that there is no indication that Congress has *ever* intended to make a change in Section 902 from foreign to U.S. concepts, even though it is clear that the statute today unequivocally contemplates the use of U.S. concepts (see U.S. Br. 39 n.17). If the statute contemplates the use of U.S. concepts today and Congress never changed it in this respect, it would follow from respondent's line of argument that the statute has always contemplated the use of U.S. concepts.

definition of income because that approach would not correctly relate the apportioned credit to the dividend reported on the U.S. return, which comes out of U.S. profits. Moreover, since the statute was designed to provide a credit equivalent to branch operations, which report income determined under U.S. concepts, it would have upset the balance for Congress to have contemplated the use of foreign profits in allocating the credit to subsidiary operations. Because the concept that Congress had to incorporate in the statute was a hybrid – a measurement of the profits of a foreign corporation intended to be used to determine the appropriate tax credit allowed to a U.S. corporation – no commonly used term in the Code was appropriate, and it was reasonable for Congress to invent a new one.[10] The phrase that it chose, "total taxable income," does not by its terms clearly refer either to foreign or U.S. concepts of income, and there is no persuasive evidence that Congress, simply by using this term in the 1918 legislation, deliberately chose the illogical and counterproductive course of using a foreign definition of income.[11]

[10] Thus, Congress could not simply have used the term "net income," as Amicus Vulcan Materials Co. suggests (Br. 7). A foreign corporation has no "U.S. corporate tax base" (*ibid.*), and therefore, strictly speaking, it has no "net income."

[11] Respondent places undue reliance on the Second Circuit's per curiam opinion in *United Dyewood Corp.* v. *Bowers*, 56 F.2d 603 (1932), aff'g 44 F.2d 399 (S.D. N.Y. 1930). The court there sought to apply the 1918 version of the statute to a case where the foreign subsidiary had paid two creditable foreign taxes – an income tax and an excess profits tax – that were imposed on overlapping foreign tax bases. While the Second Circuit stated that the term "total taxable income" referred to the foreign tax base, it is not apparent that there was any difference there between the U.S. and foreign definitions of income or that it was even suggested to the court that U.S. concepts might control; the dispute centered on the effect upon the credit of the overlap between the two tax bases. Moreover, the case was litigated and decided prior to the Treasury's statement of its position in 1933 that U.S. principles govern the definition of profits. Thus, the Second Circuit's statement concerning the meaning of a phrase that disappeared from the statute more than 65 years ago cannot be viewed as a reasoned rejection of the proposition that, where profits would be computed differently under U.S. and foreign law principles, the Section 902 credit functions properly only if "accumulated profits" are determined in accordance with U.S. principles.

Similarly, Congress's failure in 1962 to amend Section 902 to conform with language being used in the new Subpart F gives rise to no inference that Section 902 refers to profits computed under foreign law principles. Cf. National Foreign Trade Council Amicus Br. 10-12. The meaning of "accumulated profits" was by that time recognized as referring to U.S. law, and there was no reason for Congress to tamper with the existing language. See, *e.g.*, I.T. 2676, XII-1 C.B. 48, 50 (1933); *Steel Improvement & Forge Co.* v. *Commissioner*, 36 T.C. 265, 276-282 (1961), rev'd on other grounds, 314 F.2d 96 (6th Cir. 1963). Indeed, the 1962 legislative history shows Congress's understanding that Section 960 of the Code would operate under "rules * * * consistent with Section 902," which means that Congress must have understood that "accumulated profits" are computed under U.S. tax concepts. H.R. Rep. No. 1447, 87th Cong., 2d Sess. A103-A104 (1962). And that same understanding is reflected in the history of subsequent enactments in the foreign tax credit area.[12]

7. In our opening brief (at 21-22), we provide some simple examples to illustrate how respondent's interpretation of Section 902 would disrupt the proper operation of the credit by failing to correlate the percentage of the credit allowed with the percentage of earnings distributed by the foreign subsidiary. Respondent contends (Br. 39-40; see also National Foreign Trade Council Amicus Br. 18-20) that these examples are misleading, arguing that the incorrect credits yielded by the use of a foreign definition of "accumulated profits" in the government's examples are a consequence not of respondent's misinterpretation of Section 902, but rather of the government's failure to use the same foreign tax rate in all of the examples. This objection is completely misconceived. The problem illustrated by the examples is that, under respondent's interpretation, disparities between the U.S. and foreign tax base would yield either an overstatement or understatement of the credit that should be apportioned to a particular dividend. Specifically, when the U.S. tax base is lower than the foreign tax base, the credit would be too low, resulting in double taxation; the taxpayer would be denied full credit for the foreign taxes paid even when it distributes all of its earnings as a dividend. Conversely, when the U.S. tax base is higher than the foreign tax base, the credit would be too high; the taxpayer would be able to take the full credit when it does not distribute all of its earnings as a dividend. These faulty results are illustrated by the individual examples standing alone, not by a comparison of the various examples to a "base case," and therefore the results clearly are not attributable to a failure to use the same foreign tax rate in each example.

[12] See S. Rep. No. 313, 99th Cong., 2d Sess. 299 (1986); Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986*, at 858 (Comm. Print 1987) ("accumulated profits * * * were generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes"); H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 841 (1984) ("accumulated profits are essentially equivalent to earnings and profits"); S. Rep. No. 1039, 96th Cong., 2d Sess. 15 (1980).

Thus, the same point can be illustrated by changing the examples (U.S. Br. 21-22) to use a constant 20% foreign tax rate. In the second example, where the foreign definition of income yields \$180 and the U.S. definition yields \$100, the foreign tax paid at a 20% rate will be \$36, which leaves after-tax U.S. profits of \$64. If all of that \$64 of U.S. profits is distributed as a dividend, the taxpayer should receive the full credit of \$36. That is precisely the result obtained under the Section 902 formula if accumulated profits are defined according to U.S. concepts: $\$36 \times \$64/(\$100 - \$36) = \$36$. But under respondent's approach of defining accumulated profits in terms of foreign tax law concepts, the taxpayer receives only a partial credit even though the subsidiary has distributed 100% of the available earnings and profits as a dividend. If \$180 is used as the accumulated profits in the Section 902 formula, the taxpayer will receive credit for less than half of the foreign taxes paid: $\$36 \times \$64/(\$180 - \$36) = \$16$.[13] Moreover, the foreign tax that is not credited here may

[13] This point is cogently expressed in one detailed scholarly analysis of the foreign tax credit (E. Owens, *The Foreign Tax Credit* 122 (1961) (footnote omitted)):

> [I]f all the accumulated profits of a given year are distributed and if they are distributed to one stockholder this [Section 902] fraction should have

be permanently blocked because any distribution that exceeds the profits defined under U.S. law, by definition, will not be a dividend and thus will not give rise to any Section 902 credit (unless the foreign tax base in subsequent years is lower than the U.S. tax base).

If the U.S. tax base is greater than the foreign tax base, the opposite distortion will occur—namely, the taxpayer will be able to take a credit for all of the foreign tax paid even if the subsidiary does not distribute all of its earnings. Using the numbers from the third example in our opening brief with a 20% foreign tax rate, *i.e.*, $100 of U.S. income and $60 of foreign income, the foreign tax will be $12, leaving $88 in after-tax U.S. profits. By distributing only $48 of those profits, the taxpayer would be able to take a credit for all of the $12 of foreign tax paid if respondent's interpretation of Section 902 were correct. The formula would be as follows: $12 × $48/($60 – $12) = $12. This result would clearly defeat the basic statutory purpose of the Section 902 allocation formula to prevent the parent-subsidiary operation from taking the full credit when the subsidiary has retained some of the earnings (thereby insulating them from U.S. tax).[14] Conversely, this purpose is properly served if accumulated profits are defined in terms of U.S. tax concepts; in this example, that approach will permit the taxpayer to take a credit for slightly more than half

no effect on the amount of foreign tax creditable. In other words, the fraction should be one over one and the entire foreign tax should be credited. It is clear that this result will be reached only if "accumulated profits" in the denominator of the fraction is defined in exactly the same way as is the source of the "dividends" in the numerator; that is, as "earnings and profits" of the foreign corporation as computed under United States tax law.

[14] Amicus National Foreign Trade Council itself uses this example in Table V of its brief (at 20). Elsewhere in its brief, however, it recognizes the unacceptability of the result engendered by the use of a foreign definition of accumulated profits in the example. Amicus correctly states that "if a wholly owned subsidiary in a particular year distributes only a part of what is available after payment of the foreign tax, the credit should obviously not be for the full amount of the foreign tax" (Br. 5).

of the foreign tax paid, which it can apply against the U.S. taxation of a dividend that reflects a distribution of slightly more than half of the subsidiary's earnings. The formula would be as follows: $12 × $48/($100 – $12) = $6.55.

8. Respondent's contention (Br. 31-37, 41-43) that the decision below does not conflict with the longstanding administrative practice is unresponsive to our prior filings in this case and entirely without merit. The crabbed construction respondent gives to Treas. Reg. § 1.902-3(c)(1) (see Br. 31-33) has no basis in its text. Moreover, respondent's argument ignores the acknowledged fact (see Resp. Br. 42) that Rev. Rul. 63-6, 1963-1 C.B. 126, published just two years before the regulation, squarely holds that "U.S. rules should govern the determination of 'accumulated profits.'"[15] The regulation plainly carries forward the substance of the revenue ruling—namely, that "accumulated profits," like "earnings and profits," denote the source from which dividends are paid and must be calculated in accordance with U.S. principles of taxation. See U.S. Br. 33-34 & n.14.[16]

[15] As we have explained (Br. 34 n. 14; Pet. Reply Br. 5-6 & n.2), the administrative step of declaring this ruling "obsolete" does not indicate a departure from its substance.

[16] Respondent also repeats (Br. 31, 43) its contention that subparagraph (4) of the regulation supports its position. As we explained in our reply at the petition stage (at 6-7), this subparagraph does not define accumulated profits and is fully consistent with the explicit definition in subparagraph (1). We have also earlier refuted respondent's claim (Br. 10, 33, 46) that the statutory phrase "gains, profits, and income" necessarily refers to profits computed under foreign tax principles. See U.S. Pet. Reply Br. 7 n.3.

For the foregoing reasons, and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

OCTOBER 1989

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(6)

No. 88-1474

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA,

Petitioner,

v.

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

MOTION OF VULCAN MATERIALS COMPANY FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF RESPONDENT AND BRIEF OF *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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MOTION OF VULCAN MATERIALS COMPANY FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF RESPONDENT AND BRIEF OF *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

Vulcan Materials Company ("Vulcan") hereby respectfully moves for leave to file the attached brief *amicus curiae* in this case. The consent of the attorney for Petitioner has been obtained and is filed herewith. The consent of the attorney for Respondent was requested, but the attorney for Respondent declined to consent.

The interest of Vulcan in this case arises from the fact that it is a party to a case presently pending in the United States Tax Court, *Vulcan Materials Company v. Commissioner*, T.C. Docket No. 11680-88, in which a similar issue is presented, namely, whether foreign corporate income

tax law should be taken into account in determining the meaning of "accumulated profits" for purposes of the indirect foreign tax credit. The applicable foreign law in that case imposes corporate income tax on *only* a U.S. shareholder's allocable portion of the profits of a local corporation owned by both nationals of the foreign country and U.S. residents. In the pending Tax Court case, Vulcan's position is that this aspect of foreign tax law must be recognized, and the term "accumulated profits" must be interpreted as including only that proportion of profits actually subject to foreign corporate income tax. The Commissioner of Internal Revenue (the "Commissioner"), by contrast, takes the same position in the pending Tax Court case that he took in Revenue Ruling 87-14, 1987-1 C.B. 181, namely, that the term "accumulated profits" cannot be determined by reference to foreign law because the term "accumulated profits" is defined *solely* by reference to U.S. corporate income tax law. The Commissioner's position in Revenue Ruling 87-14 is the essence of Petitioner's position in the instant case, although the setting is different.

In the instant case in the Court of Appeals, there was considerable discussion by both Petitioner and Respondent concerning the legislative history of the term "accumulated profits" in the indirect foreign tax credit provisions. Nevertheless, significant omissions exist in that discussion, especially with respect to the legislative history and evolution of those provisions in U.S. tax laws *prior* to the Revenue Act of 1921, ch. 136, 42 Stat. 259. The brief that Vulcan is requesting permission to file as *amicus curiae* contains a complete analysis of the relevant sections of that prior legislative history and reveals a critical aspect, which has not been previously addressed by either Petitioner or Respondent.

Moreover, because of Vulcan's concern that Petitioner's position herein, if upheld by this Court, will automatically apply to other factual and legal settings, Vulcan believes that the brief it is requesting leave to file as *amicus curiae* contains analyses of such settings that are not likely to be addressed by either Petitioner or Respondent in the

instant case. Vulcan therefore moves for leave to file a brief *amicus curiae* because it believes that the brief will assist this Court in reaching the proper result in this case.

Respectfully submitted,

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September 5, 1989

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On Writ Of Certiorari To
The United States Court Of Appeals
For The Federal Circuit

BRIEF OF VULCAN MATERIALS COMPANY AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

Vulcan Materials Company respectfully submits this brief as amicus curiae in support of the Goodyear Tire & Rubber Company and Affiliates.

INTEREST OF THE *AMICUS CURIAE*

Vulcan Materials Company ("Vulcan"), a New Jersey corporation with its principal place of business in Birmingham, Alabama, is engaged in the production and sale of construction materials, chemicals, metals and related products.

Vulcan's interest in this case arises from the fact that it is a party to a pending United States Tax Court case,

Vulcan Materials Company v. Commissioner, T.C. Docket No. 11680-88, challenging the validity of Revenue Ruling 87-14.[1] Vulcan believes that the decision in this case may have a direct effect upon the outcome of its Tax Court case.

SUMMARY OF ARGUMENT

In arguing that foreign law must be disregarded totally in determining "accumulated profits," Petitioner has misread the legislative history, ignored its own counsel, and has assumed an inflexible position that frustrates Congress' purpose in enacting section 902 of the Internal Revenue Code (the "Code").[2]

Petitioner has not answered and cannot answer one simple question: Why did Congress purposefully avoid equating "accumulated profits" (and its precursors) with "earnings and profits" (and its precursors) when the earliest version of the indirect foreign tax credit was enacted, and when substantive changes were later made?

Petitioner's insistence that total disregard of foreign tax law is the sole means of achieving the purposes of the section 902 credit is wrong. Such total disregard produces the very results Petitioner decries—double taxation and lack of equivalent tax treatment of branches and subsidiaries. Moreover, in recent regulations and in interpreting section 902 under the U.S.-U.K. Tax Treaty, Petitioner has actually admitted that a rigid disregard of foreign law is incorrect.

Finally, Petitioner asserts that only its position can avoid opening up a Pandora's box of "vagaries of foreign law," implying that courts cannot take into account that law as necessary. To the contrary, courts have done so when dealing with other aspects of the foreign tax credit, as

[1] 1987-1 C.B. 181.

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue.

has Congress, and even, on occasion, the Internal Revenue Service ("IRS").

Congress intended that the indirect foreign tax credit be applied so as to avoid double taxation. Petitioner suggests a wholly inflexible rule that will frustrate Congress' purpose. This Court should not hold that foreign law can never be taken into account in determining "accumulated profits" for purposes of section 902.

ARGUMENT

I. PETITIONER INCORRECTLY ARGUES THAT THE TERM "ACCUMULATED PROFITS" IS SYNONYMOUS WITH THE TERM "EARNINGS AND PROFITS" AND IS TO BE COMPUTED TOTALLY WITHOUT REGARD TO THE OPERATION OF FOREIGN TAX LAW.

By framing the issue as whether "accumulated profits" under section 902(a) are to be computed under U.S. or foreign tax law,[3] Petitioner "focuses its beam on the wrong spot"[4] and thus would lead this Court to the wrong result.

Petitioner urges the Court to utilize this case as an occasion to resolve all conflicts between the laws of the U.S. and of foreign countries regarding the determination of "accumulated profits" in favor of the preemptive application of "U.S. tax rules." Such a result would follow directly from the holding, urged by Petitioner, that the term "accumulated profits" as used in section 902 is syn-

[3] Petitioner's Brief ("Pet. Br.") at 4.

[4] Dale, *The Reformed Foreign Tax Credit: A Path Through the Maze*, 33 Tax L. Rev. 175 (1978), where certain source rule amendments, enacted in 1976, are compared to "the drunk searching at night under a street lamp. Asked what he was looking for, he replied it was his watch, which he had lost in the adjacent park. When further queried why he was looking under the street lamp if the watch had been lost elsewhere, he answered, 'Because the light is better here.' " *Id.* at 195.

onymous with the term "earnings and profits" as used in section 316.[5]

The issue in this case, however, is much narrower than Petitioner suggests: Whether the accumulated profits from which a dividend is paid by a foreign subsidiary should be "sourced" in either (i) the same taxable year in which foreign taxes actually were imposed on such profits, or (ii) in a different taxable year in which U.S. taxes would have been imposed on such profits had they been earned by a domestic corporation.[6] Stated differently, the issue presented here is a sourcing or "ordering" issue, not a definitional issue.

The sole issue in dispute is in which year the accumulated profits from which the dividend was paid should be sourced. If the profits are sourced in a *prior* year, consistent with foreign law ordering rules, then a credit should be allowed for such prior year's taxes. If the profits are sourced in the *current* year, consistent with U.S. law ordering rules (as if the foreign subsidiary were a domestic corporation), then no credit should be allowed if no foreign taxes were paid in that year.

Even if we follow Petitioner's beam to the wrong spot, and view the issue as a definitional issue, rather than an ordering issue, an examination of the statutory definition

[5] Pet. Br. at 25. Petitioner does concede the existence of narrow definitional differences between the two terms, such as the fact that "accumulated profits" is an annual concept, requiring identification of the particular taxable year or years in which such profits have been accumulated—an "ordering" or "sourcing" exercise with respect to an amount which is used for no other purpose under the Code than the calculation of the section 902(a) fraction—whereas "earnings and profits" is an aggregate or cumulative concept, denoting the totality of the multi-year fund of profits and surplus available for distribution as a dividend. Pet. Br. at 25 n.11. Within a single taxable year, the terms are, in Petitioner's view, otherwise synonymous. *But see Goodyear Tire & Rubber Co. v. United States*, 14 Cl. Ct. 23, 28 (1987), *rev'd*, 856 F.2d 170 (Fed. Cir. 1988) (denying the equivalence of the two terms).

[6] Respondent has similarly framed the issue. Respondent's Brief in Opposition 3-6.

of "accumulated profits," and of its legislative history, strongly suggests that the definition urged here by Petitioner is wrong. Equally important, Petitioner's rigid equation of "accumulated profits" with "earnings and profits," if ever accepted, would operate to preclude the ability to reach pragmatic solutions in section 902 cases—in the words of the Tax Court in *Champion*, "sensible results"—in this area "fraught with complex definitional concepts and requiring the meshing of U.S. tax laws with those of foreign countries."[7]

A. Legislative History.

From 1921[8] until 1986,[9] U.S. tax law defined "accumulated profits" as "the amount of gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income." The Court of Appeals in the decision below concluded that the "plain meaning" of this statutory phrase was the income of the foreign subsidiary on which the taxes are imposed, net of the taxes imposed.[10] Since the relevant taxes are imposed by a foreign jurisdiction, and since the relevant income is that on which the foreign jurisdiction imposes the taxes, it is not illogical to conclude that the income in question is the foreign tax base. To reject such a plain meaning interpretation, something more should be required than Petitioner's conclusory and cavalier reference to its own regulations.[11] Even unassisted

[7] *Champion Int'l Corp. v. Commissioner*, 81 T.C. 424, 436-437 (1983), *acq.*, 1984-1 C.B. 1.

[8] Revenue Act of 1921, § 238(e), ch. 136, 42 Stat. 259.

[9] Section 1202(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2528, substituted the term "post-1986 undistributed earnings" for "accumulated profits" and generally eliminated the issue presented in this case for post-1986 years.

[10] *Goodyear Tire & Rubber Co. v. United States*, 856 F.2d 170, 172 (Fed. Cir. 1988), *rev'g* 14 Cl. Ct. 23 (1987).

[11] Pet. Br. at 33, referring to Treas. Reg. § 1.902-3(c)(1) (1965) (now Treas. Reg. § 1.902-1(e)), which defines accumulated profits to mean "the sum of (i) the earnings and profits of such corporation for such

logic would cause one to question why accumulated profits should be equated with U.S. earnings and profits which, in addition to not being the base on which the foreign taxes are imposed, is not even the base upon which U.S. taxes are imposed.

Nevertheless, it is this odd-seeming equation between accumulated profits and earnings and profits that Petitioner asks this Court to adopt. Failure to so define the term, Petitioner argues, will result in disparate treatment for foreign subsidiaries and branches.[12] While there is a sound answer to this argument, as discussed below, a critical point should be noted initially which Petitioner *fails* to argue. Petitioner fails to argue that Congress unambiguously intended to define accumulated profits as synonymous with U.S. earnings and profits. Unable to assert credibly this argument, Petitioner implies that Congress, in enacting the above-quoted statutory definition of accumulated profits, was either wrong or unintentionally vague in formulating its definition.

Examination of the legislative history of section 238(e) of the Revenue Act of 1921, ch. 136, 42 Stat. 259, the combined predecessor of both section 902(a) and section 902(c)(1), reveals that Congress was quite deliberate and precise in its use of terminology in that provision. If any mistake has been made, therefore, it is not Congress', but Petitioner's, in failing to interpret the statute in accordance with its terms and, to compound the error, in failing to heed the advice of an IRS Chief Counsel's memorandum[13] that the regulatory definition be modified so as to achieve the intended coordination of foreign and domestic law.

Section 238(e) was enacted to correct a serious defect in section 240(c) of the Revenue Act of 1918, ch. 18, 40

year, and (ii) the foreign income taxes imposed on or with respect to the gains, profits and income to which such earnings and profits are attributable."

[12] Pet. Br. at 11, 14-15.

[13] G.C.M. 36814 (Aug. 18, 1976), discussed at Pt. I, Sec. B., *infra*.

Stat. 1082, the earliest predecessor of modern section 902. Section 240(c) allowed an indirect foreign tax credit that was computed by multiplying foreign taxes paid during the taxable year by the fraction of dividends over "total taxable income" of the foreign corporation for such year. The amount of the credit was limited to the amount of the dividend.

Two aspects of section 240(c) are significant here. First, Congress elected to use as the formula's denominator a term, "taxable income," *that was not used anywhere else in the Revenue Act of 1918* (nor in the Revenue Acts of 1913, 1916, 1917 or 1921) *and had no other generally accepted tax law meaning during that period.* Had Congress intended a U.S. concept of taxable income (in the modern, section 63 sense), the proper term to describe that concept was close at hand: The Revenue Act of 1918, like the Revenue Acts of 1913, 1916, 1917 and 1921, used the term "net income" to describe the U.S. corporate tax base (gross income less allowable deductions).[14] That the term "net income" was not used in section 240(c) thus cannot be ascribed to inadvertence. Rather, it was a deliberate choice *not* designed to ensure the foreign mirror image of U.S. net income. Indeed, the Court of Appeals for the Second Circuit, in *United Dyewood Corp. v. Bowers*,[15] considered it "entirely clear" that the term "taxable income" in the 1918 Act meant "the sum used by the foreign government as a base to compute the foreign tax."

The second significant aspect of section 240(c) is that its use of a "taxable income" denominator operated to limit the indirect credit to foreign taxes paid in the foreign corporation's current taxable year. Section 240(c) thus lacked a mechanism for sourcing to a prior year the earnings from which a dividend was paid. Unless the foreign

[14] Revenue Act of 1913, ch. 16, § G.(a), 28 Stat. 172; Revenue Act of 1916, ch. 463, § 10, 39 Stat. 765; Revenue Act of 1917, ch. 63, § 10(a), 40 Stat. 333; Revenue Act of 1918, ch. 18, § 230(a), 40 Stat. 1075; Revenue Act of 1921, ch. 136, § 230, 42 Stat. 252.

[15] 56 F.2d 603 (2d Cir. 1932).

subsidiary remitted all of its earnings annually, a credit for some portion of the foreign taxes paid on its prior year earnings would be permanently lost and double taxation would result.[16]

Section 238(e) of the Revenue Act of 1921 remedied this problem by substituting the term "accumulated profits" for "taxable income" as the denominator of the indirect credit fraction. The clear intent of this change was to permit earnings out of which the foreign subsidiary's dividend was paid to be sourced in a prior year, and to permit credits to be claimed for foreign taxes paid on such earnings when distributed in a later year. It is this change that provides equivalent treatment for branches and subsidiaries,[17] and thus achieves the legislative purpose.

Petitioner, remarkably, does not dispute this point.[18] But it is a point that gravely undermines its position. The 1921 Act's use of "accumulated profits" was intended to create

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[16] As explained in *American Chicle Co. v. United States*, 316 U.S. 450, 453 (1942): "The difficulty with [section 240(c)] was that it did not relate the credit to the accumulated profits or surplus of the subsidiary out of which the dividends were paid."

[17] As noted by Senator Smoot, the amendment's sponsor:

> In such a case a foreign subsidiary is much like a foreign branch of an American corporation. If the American corporation owned a foreign branch, it would include the earnings or profits of such branch in its total income, but it would also be entitled to deduct from the tax based upon such income any income or profits taxes paid to foreign countries by the branch in question. Without special legislation, however, no credit can be obtained where the branch is incorporated under foreign law.

61 Cong. Rec. 7184 (1921). *See also Internal Revenue: Hearings on H.R. 8245 before the Senate Committee on Finance*, 67th Cong., 1st Sess. 389 (1921) (statement of Dr. Adams, U.S. Department of Treasury).

[18] Pet. Br. at 26-32. The point is of course well-acknowledged elsewhere. *See Goodyear Tire & Rubber Co. v. United States*, 14 Cl. Ct. 23, 30 (1987), *rev'd*, 856 F.2d 170 (Fed. Cir. 1988); *see also Champion Int'l Corp.*, 81 T.C. at 436; *Associated Tel. & Tel. Co. v. United States*, 306 F.2d 824, 827-828 (2d Cir. 1962).

a sourcing mechanism. That sourcing mechanism permitted foreign taxes imposed on prior years' earnings to be released as credits when such earnings were distributed in a later year, rather than being "frozen" in the year paid and thus permanently unrecoverable. The intended parity was thus established between the indirect credit for foreign taxes paid on a foreign subsidiary's profits and the direct credit for foreign taxes paid on a foreign branch's income. Because foreign taxes on branch income are by definition foreign taxes imposed on the income of the U.S. taxpayer itself, they are of course not susceptible to being "frozen" in the year paid and thus permanently lost as credits. It is precisely this sourcing mechanism, enacted in 1921 to create such parity, which Petitioner would eviscerate in the instant case, thus defeating the Congressional objective.

This is not the only fundamental flaw in Petitioner's reading of the 1921 Act's legislative history. Having failed to recognize Congress' deliberate choice of "taxable income" over U.S. "net income" in the 1918 Act's original formulation, Petitioner compounds the omission by failing to offer any evidence, or even speculation, as to why Congress in the 1921 Act would suddenly have opted for U.S. earnings and profits.

Petitioner further neglects to mention that the term "net income," which was used to describe the U.S. corporate tax base in every tax act from 1913 to 1921, was in fact inserted for the first time by the 1921 Act into the very same indirect credit provision (section 238(e)) which contained the term "accumulated profits." The purpose of inserting that term was to replace the 1918 Act's limitation on the credit (the amount of the dividend) with a separate limitation, measured by the proportion of U.S. tax equal to the ratio of foreign subsidiary dividends to the domestic corporation's "entire net income." This ratio constituted an early version of the modern section 904 limitation.

This newly-created foreign tax credit limitation demonstrates beyond doubt that the Congress that enacted

section 238(e) was entirely capable of specifying the application of U.S. tax concepts where it saw fit. That Congress saw fit to so specify with respect to the denominator of one limitation (*i.e.*, the section 904 limitation), while at the same time not so specifying with respect to the denominator of the other (*i.e.*, the section 902 limitation), utterly negates the possibility of an accidental omission.

Further, had Congress intended for the denominator of the section 902 formula to be U.S. earnings and profits, it could merely have incorporated that term from then-existing terminology. The original predecessor of section 316 of the Code was section 10 of the Revenue Act of 1916, which defined a dividend by reference to "earnings or profits." That original definition was reenacted, without material change, in all successor tax acts, including the Revenue Act of 1921.[19]

Thus, having first used the term "earnings or profits" in 1916 to define a dividend, and having used the term "dividend" as the numerator of the section 902 fraction beginning in 1918, Congress failed to use the term "earnings or profits" to describe the denominator of that fraction in any subsequent tax act. Petitioner's brief is silent as to why, if Congress intended that meaning, it did not merely incorporate that definition into the statute either explicitly or by cross-reference. Petitioner's brief is also silent as to why, if Congress intended the use of a known domestic tax concept, it elected to use for this purpose (as it had in the original 1918 Act version) a specially-defined term that had no predecessor or preexisting meaning in either statutory or nonstatutory tax terminology. Congress' decision not to use parallel terminology compels the conclusion that parallel meanings were not intended.

In *Biddle v. Commissioner*,[20] this Court established a presumption in favor of the application of domestic tax

[19] The disjunctive formulation, "earnings or profits," was replaced by the conjunctive formulation, "earnings and profits," in the 1954 Code. *See* Internal Revenue Code of 1954, § 316(a), Pub. L. No. 83-591, 68A Stat. 3, 98-99.

[20] 302 U.S. 572 (1938).

rules, unless a statute "by express language or necessary implication" compels the opposite conclusion.[21] Petitioner cites *Biddle* for the proposition that Congress generally intends the use of "its own criteria."[22] Ironically, in arguing that the term "accumulated profits" means "U.S. earnings and profits," Petitioner is seeking to attribute to the term a meaning quite different than the one that Congress itself provided. Thus, it is Petitioner, not Respondent, that is attempting to overcome the presumption established in *Biddle* by substituting its own criterion for that of Congress.

B. The Commissioner's Rigid Application of U.S. Tax Concepts in the Section 902 Context.

Historically, the rigid application of U.S. tax concepts in the section 902 context by the Commissioner of Internal Revenue (the "Commissioner") has led to egregious results and has culminated in numerous instances of double taxation. Specifically, the Commissioner, as in the present case, has adopted a totally arbitrary and inflexible position that "U.S. tax law" applies in determining "accumulated profits" for section 902 purposes.

The Commissioner's position with respect to the ordering issue was perhaps best exemplified in the *Champion* case, when he "frankly admitted" that his theory—

> "will under some limited circumstances result in double taxation," the avoidance of which, he concedes, is the "fundamental purpose of the foreign tax credit provisions." He argues, however, that the frustration of the purpose of the foreign tax credit, at least in the "limited circumstances" of this case is "unavoidable from the necessity of adhering to United States legal concepts in computing accumulated profits for purposes of the

[21] 302 U.S. at 578.

[22] Pet. Br. at 12.

denominator of the section 902 of the Code deemed-paid credit fraction."[23]

The Tax Court's response to this position was succinct: "[W]e do not think that 'United States legal concepts' make the imposition of double taxation unavoidable."[24] Petitioner's position is no different in the instant case and deserves a like response.

Is there truly no reasonable method available for carrying out the section 902(c)(1) mandate to order or source among particular years a foreign subsidiary's profits from which a dividend is paid without wholly disassociating such profits from the foreign taxes actually imposed on them? Fortunately, the objective of section 902(c)(1) has not proven an unsolvable mystery to the courts. As observed in *General Foods Corp. v. Commissioner*:

> To properly give effect to the language of [section 902(a)(1) and (c)(1)], . . . it is necessary to relate the tax credit to the particular year or years in which the accumulated profits (from which the dividends were paid) were earned and taxed.[25]

And the court in *H.H. Robertson Co. v. Commissioner*, similarly described the provision's clear objective as follows:

> It is of critical importance to determine the "accumulated profits" of each year, so that they can be matched against the foreign taxes paid for *that* year, and so that such dividends are paid "out of" or "from" such "accumulated profits," a foreign tax credit may properly be computed as a portion (in accordance with the statutory formula) of the foreign taxes paid in respect of the "accumulated profits" of *that* year.[26]

[23] *Champion Int'l Corp.*, 81 T.C. at 436 n.19.

[24] *Id.*

[25] 4 T.C. 209, 216 (1944).

The *Champion* court criticized the Commissioner's strict adherence to U.S. concepts in that case. The Commissioner refused to recognize the effect of the Canadian law loss carryback rules for ordering purposes, creating "a distortion in the amount of the 'deemed paid' credit" such that "a portion of the accumulated profits of 1969 could *never* be distributed" and thus the foreign taxes paid thereon could *never* be claimed as credits.[27] Such a rigid and inflexible application of U.S. tax principles, wholly impervious to the policy and purpose of sections 902(a) and (c)(1), could not have been intended and should not be permitted:

> The purpose of U.S. tax principles in the context of section 902 is to establish a correlation between the foreign taxes paid on the foreign subsidiary's accumulated profits of a particular year and the dividends paid from the same year's accumulated profits. To ignore the fact that foreign law computes the tax liability by allowing for loss carrybacks is to assure that this correlation will be lost.[28]

Confronted with the unambiguous directive of section 902(c)(1) and its legislative history, and with the rather clear-eyed guidance contained in nearly half a century of court decisions, it is simply inexplicable why the Commissioner has refused to coordinate the ordering rules of foreign and domestic law in a manner consistent with that legislative directive and judicial guidance—even in the face of compelling evidence that the failure to do so produced double taxation.

Instead of attempting to cure this failure, the Commissioner has actually compounded his error by taking liti-

[26] 59 T.C. 53, 79 (1972), *aff'd*, 500 F.2d 1399 (3d Cir. 1974).

[27] *Champion Int'l Corp.*, 81 T.C. at 434-435.

[28] 81 T.C. at 440.

gating positions (as in *Champion*) and issuing rulings (such as Revenue Ruling 74-550,[29] discussed *infra*) that merely highlight, rather than justify, the inadequacies inherent in his rigid application of U.S. tax principles.

Revenue Ruling 74-550 addressed the ordering issue in connection with a foreign subsidiary's net operating loss, which produced a deficit for U.S. earnings and profits purposes in the affected year, but which arose in a foreign jurisdiction whose laws did not provide for a carryback of the loss.[30] The Ruling held that the deficit had the effect of "zeroing out" U.S. earnings and profits in an earlier year, even though foreign taxes were paid in that year. Under the Ruling's strict adherence to U.S. ordering concepts, no dividend could ever be paid out of the earlier year and, thus, the foreign taxes paid in that year could never be credited against the taxpayer's U.S. tax liability.

Revenue Ruling 74-550 demonstrates that rigid adherence to U.S. tax concepts, in the section 902 context, can leave a portion of the profits actually accumulated by a foreign subsidiary, and a portion of the foreign taxes actually paid on such profits—like the Queen's jam—*permanently inaccessible*:

> "The rule is, jam tomorrow, and jam yesterday—but never jam today."
>
> "It must come sometimes to 'jam today,' " Alice objected.
>
> "No, it can't," said the Queen. "It's jam every other day: today isn't any other day, you know."[31]

It is noteworthy that in 1976, the IRS Chief Counsel, confronting yet another graphic example of the anomalous results that would be produced by rigid application of U.S. ordering rules for section 902 purposes, urged the adoption

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[29] 1974-2 C.B. 209.

[30] *Id.*

[31] Lewis Carroll (Charles Lutwidge Dodgson), *Alice's Adventures in Wonderland* 5 (1865).

of ordering rules that would conform to those of foreign law.[32] Specifically, G.C.M. 36814 involved the application of section 902 to a liquidating distribution from the U.K. subsidiary of a domestic corporation.[33] Although the subsidiary had income in excess of losses in the aggregate, its earnings history for the relevant period included profit years, followed by loss (deficit) years, followed by additional profit years. While U.S. ordering rules, as interpreted in Revenue Ruling 74-550, required that the deficit be carried back and offset the profits in earlier years, U.K. law required that the loss be carried forward to succeeding years. The result was that U.S. earnings and profits were entirely offset or significantly reduced in the years in which the U.K. levied tax. Conversely, there was little or no U.K. tax in the years in which the U.S. recognized earnings and profits.

On a more extreme version of these facts, the same overlapping application of U.S. and U.K. ordering rules could have produced a situation in which the U.S. deficit offset all the earnings and profits of prior years, while the U.K. loss carryforward produced a total refund of U.K. tax in the subsequent years. The result in such a situation, under Petitioner's position in the instant case, would be that the liquidating dividend would bear no foreign tax credits at all. Perhaps even more astonishing is that, under Petitioner's view,[34] there would be no double taxation because the dividend is paid out of earnings for years in which no foreign taxes were paid, even though the actual effective rate of tax paid on the distributed earnings in aggregate would equal the combined tax rates of the two

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[32] G.C.M. 36814 (Aug. 18, 1976). A General Counsel's Memorandum was, in 1976, an internal document expressing the legal opinion of the Interpretative Division in the IRS Office of Chief Counsel. Subsequent litigation compelled the disclosure of these documents.

[33] Under section 367(b) and the temporary regulations thereunder, a liquidating distribution is treated as a dividend for U.S. purposes to the extent of the subsidiary's earnings and profits. Temp. Treas. Reg. § 7.367(b)-5.

[34] Pet. Br. at 46.

countries. To determine the existence of double taxation solely with reference to the laws of the U.S. assumes away the possibility of double taxation and totally defeats the Congressional purpose underlying section 902.

G.C.M. 36814 was in full agreement. The case of the liquidating dividend, according to G.C.M. 36814, was illustrative of—

> the inequitable and discriminatory position the taxpayer is placed in where the Service fails to make an adjustment to the ordering rules to correlate the foreign taxable income that produced the foreign tax with the foreign taxable income that is the source of the dividend distribution.

G.C.M. 36814 concluded that "an interpretation of Code § 902 that would permit this result would conflict with the legislative purpose of that section as well as being logically indefensible." Because Petitioner insists that foreign tax law is irrelevant in connection with section 902, Petitioner would have this Court uphold this "logically indefensible" scheme in the present case.

The solution proposed in G.C.M. 36814 was to allocate the loss (deficit) of the intervening year first *according to U.K. tax law rules*. The result would be that U.S. earnings and profits would be sourced in the same years as the U.K. taxes imposed on them, and the purpose of section 902 thus would be accomplished.

However, instead of adopting such a solution, the IRS has rejected G.C.M. 36814 in favor of continued rigid adherence to U.S. tax law ordering concepts.[35] The IRS would disingenuously dismiss the anomaly described in G.C.M. 36814 as "one of the many aspects of foreign law which affect the effective rate of foreign tax."[36]

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[35] Rev. Rul. 87-72, 1987-2 C.B. 170.

[36] *Id.*

II. TOTAL DISREGARD OF FOREIGN LAW IN COMPUTING "ACCUMULATED PROFITS" WOULD CAUSE DOUBLE TAXATION AND LEAD TO ANOMALOUS RESULTS.

Petitioner's fundamental argument is that foreign law concepts of taxable income have "no bearing" on the application of the section 902 formula[37] and, therefore, must be disregarded. According to Petitioner, only by looking solely to U.S. tax concepts can the Congressional purpose be achieved: to avoid double taxation;[38] to equate the U.S. tax treatment of foreign branches with subsidiaries;[39] and, in general, to avoid "eccentric"[40] and "irrational results and disparities."[41]

Petitioner's position that U.S. tax concepts are controlling does not end with the application of U.S. ordering rules. Petitioner would have this Court hold that U.S. tax concepts control *every aspect* of the computation of accumulated profits for section 902 purposes and, in the process, give this Court's blessing to such collateral, but equally "irrational" and "eccentric" positions as the one adopted in Revenue Ruling 87-14.[42]

Revenue Ruling 87-14 addressed the application of the section 902 formula to Saudi Arabian "mixed companies," *i.e.*, companies incorporated under the laws of Saudi Arabia that are owned in part by Saudi nationals and in part by nonnationals. As the Revenue Ruling explains, under Saudi corporate tax law, corporate income tax is imposed *only* on the share of the mixed company's profits attributable to the non-Saudi shareholders. Consequently, those profits attributable to Saudi shareholders bear *no* corpo-

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[37] Pet. Br. at 11. *See* Pet. Br. at 10 (denominator of formula "must be defined in terms of United States tax principles"), 14-15.

[38] Pet. Br. at 11, 14-15.

[39] Pet. Br. at 17.

[40] Pet. Br. at 22.

[41] Pet. Br. at 15.

[42] 1987-1 C.B. 181.

rate income tax, but those attributable to non-Saudi shareholders bear corporate tax at the full statutory rate.

The mixed company, which was owned 50 percent by a U.S. corporation and 50 percent by a Saudi national, had 200x in pre-Saudi corporate income tax profits for the year at issue. Under the Saudi tax law previously described, only half the profits (the non-Saudi shareholder's portion) bore Saudi corporate income tax at the Saudi statutory rate of 45 percent, resulting in 45x of corporate income tax being imposed on 100x of profits. The Revenue Ruling notes that the U.S. shareholder's share of the profits bore the *entire* Saudi corporate income tax upon distribution. Thus, on distribution of all profits, the U.S. shareholder would receive only 55x, *i.e.*, 100x in pre-tax profits less the 45x in income tax imposed on those profits.

The "sensible result"[43] on these facts should be that, under the section 902 formula, the U.S. shareholder is allowed all 45x of the Saudi corporate income tax as indirect foreign tax credits. To achieve this sensible result, however, the term "accumulated profits" in the section 902 formula must be limited to that portion of the Saudi company's profits allocable to the non-Saudi shareholder and actually subject to Saudi corporate income tax. *In other words, the accumulated profits denominator must be determined in a manner that accords due regard to the peculiarities of foreign law.*

Predictably, however, Revenue Ruling 87-14 held that the denominator must include *all* profits of the Saudi company, regardless of the fact that half of such profits bore no foreign tax. The justification: "There is nothing in either the Code or regulations" that provides for modifying the denominator of the section 902 formula to recognize the effect of foreign tax law. The result is that, when the 55x (the entire after-tax income attributable to the U.S. shareholders) is fully distributed to the U.S. shareholder, it is entitled only to 16x of the Saudi corporate income taxes

[43] *Champion Int'l Corp.*, 81 T.C. at 437.

as an indirect credit, although that 55x dividend bore all 45x of such taxes. Assuming a U.S. corporate income tax rate of 46 percent, the dividend would bear an additional 16.67x in U.S. income tax, resulting in a combined effective tax rate of almost 62 percent.[44]

The rigid position adopted by the Commissioner in Revenue Ruling 87-14 clearly results in double taxation. To avoid double taxation, profits should bear a combined tax at an effective rate no higher than the higher of the two applicable tax rates. However, the combined tax rate that results from the holding in Revenue Ruling 87-14 is almost 62 percent. By contrast, if the IRS had properly taken into account the operation of Saudi corporate tax law, the combined tax rate would have equalled the assumed U.S. rate of 46 percent—precisely the result needed to avoid double taxation.

The holding of Revenue Ruling 87-14 also destroys any possibility of realizing the legislative goal of equivalence between the taxation of a foreign branch and a foreign subsidiary. If the U.S. shareholder in Revenue Ruling 87-14 had been a partner in a Saudi partnership, rather than a shareholder in a Saudi corporation, the Saudi income tax imposed on its share of the partnership's profits would have been fully creditable for U.S. tax purposes. Thus, under the holding of the Revenue Ruling, the tax burden of the U.S. corporate investor changes dramatically if that investor chooses a foreign corporate form for its investment rather than branch form.[45] Petitioner does not con-

[44] The 55x dividend would be "grossed up" under section 78 of the Code by the 16x in allowable Saudi taxes, for total income of 71x. At 46 percent, this would result in 32.67x of U.S. taxes, or 16.67x of U.S. taxes in excess of the 16x in Saudi taxes allowed as credit. Accordingly, the 100x of pre-Saudi tax profits of the mixed company would bear 45x in Saudi tax and 16.67x in additional U.S. income tax, for a total of 61.67x of income tax on 100x of profits.

[45] Where a U.S. corporation owns an interest in a foreign partnership, such interest is treated as if it were a branch of the U.S. corporation. For instance, in Revenue Ruling 80-293, 1980-2 C.B. 128, the IRS ruled that the incorporation of a foreign partnership's assets caused a U.S.

test that section 902 requires the avoidance of such a disparity. However, Petitioner is incorrect in arguing that rigid adherence to U.S. tax concepts, and complete disregard of foreign tax law, is the proper path to foreign tax credit parity between branches and subsidiaries.[46]

Reversing the situation described in Revenue Ruling 87-14 further illustrates the "eccentric" and "irrational results and disparities" mandated by Petitioner's position. Assume foreign tax law imposed corporate tax only on that share of a company's profits attributable to a resident shareholder, and exempted from corporate tax the profits attributable to the U.S. corporate shareholder. Following Petitioner's position, the U.S. shareholder could use a portion of the foreign corporate taxes paid to offset its U.S. income taxes on a dividend, even though the profits out of which such dividends were paid did not, in fact, bear any foreign tax.[47] This would produce precisely the "substantial windfall" in the form of "phantom taxes deemed paid" which the Claims Court found opprobrious in its decision below.[48]

These "eccentric" and "irrational results and disparities" of the holding in Revenue Ruling 87-14 arise from disregarding the section 902 formula's intended purpose of properly allocating the foreign tax among the foreign corporation's shareholders. As the Tax Court stated in *Champion*, one fundamental purpose of the section 902 formula—

corporate partner to be subject to the "branch loss recapture" rule enunciated in Revenue Ruling 78-201, 1978-1 C.B. 91, in the same manner as if the U.S. corporation had incorporated a branch.

[46] Pet. Br. at 26-32.

[47] On the facts of Revenue Ruling 87-14, this would permit the U.S. shareholder to receive a dividend of 100x which, after credit for a portion of the taxes borne by the foreign shareholder's share of the profits, would bear a "residual" U.S. tax only slightly in excess of 30 percent, well below the assumed 46 percent rate.

[48] *Goodyear Tire & Rubber Co.*, 14 Cl. Ct. at 30-31.

> is to allocate to each shareholder . . . its share of the credit resulting from the taxes paid by the foreign corporation on the share of the accumulated profits received by that shareholder.[49]

This purpose can *only* be realized if the section 902 formula, particularly the term "accumulated profits," is determined by taking into account foreign tax law as necessary and appropriate in particular cases to carry out the underlying purposes of section 902, and can not possibly be realized by wholly disregarding foreign law in all cases.

In recently issued regulations, Petitioner has expressly adopted a position contrary to his position here and in Revenue Ruling 87-14. Treasury Regulations section 1.904-6(a)(1)(i) enunciates the following general principle:

> [Foreign] [t]axes are related to income if the income is included in the base upon which the tax is imposed. If, for example, foreign law exempts certain types of income from foreign taxes, . . . then no taxes are considered to be related to such income . . . .

This regulation explicitly recognizes the critical connection between foreign taxes and the income on which such taxes are imposed, and redefines that income to exclude income not taxed under foreign tax law, notwithstanding that such income, under U.S. tax concepts, would be fully taxable.

Treasury Regulations section 1.904-6(b)(2) elaborates on that general principle by providing:

> If a taxpayer receives or accrues a dividend from a noncontrolled section 902 corporation, and if the Commissioner establishes that there is an agreement, express or implied, that such dividend is paid out of a designated pool of earnings of the foreign corporation, then only the foreign

[49] *Champion Int'l Corp.*, 81 T.C. at 437.

taxes imposed on that pool of earnings will be considered to be taxes related to the dividend.[50]

This latter rule would apply to the situation in Revenue Ruling 87-14 to reverse the holding therein, unless the Commissioner takes the position that no "express or implied" agreement exists in that case, because the pool of earnings is created by foreign tax law. Simply put, Petitioner has effectively admitted through these regulations, contrary to its position in this case,[51] that foreign tax law has a necessary and critical relationship to the determination of the "accumulated profits" amount to be used in the section 902 formula.

Significantly, Petitioner—again, contrary to its position in this case and in Revenue Ruling 87-14—has also taken U.K. tax law into account in interpreting "accumulated profits" for section 902 purposes in the context of the U.K.-U.S. Tax Treaty (the "Treaty").[52] Under U.K. law, an "advance corporation tax" ("ACT") is levied on the profits of a U.K. corporation. Under the Treaty, U.S. corporate shareholders in a U.K. corporation are entitled to a partial refund of the ACT on distributed dividends.[53] The unrefunded balance is treated, under the Treaty, as a tax imposed on the distributing U.K. corporation.[54] Accordingly, such unrefunded portion is eligible for credit as a tax deemed paid by the U.S. shareholder under section 902.

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[50] Although the quoted regulations provisions were not in effect for the years were at issue, they do not purport to interpret any intervening amendment to section 902.

[51] Pet. Br. at 32-34.

[52] Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Dec. 31, 1975, *reprinted in* III Tax Treaties (PH) ¶ 89,030-59.

[53] *Id.* at art. 10(2)(a)(i).

[54] *Id.* at art. 23(1)(c).

However, calculating the "accumulated profits" in the section 902 formula solely by reference to U.S. tax concepts would result in understating the deemed paid credit for the unrefunded ACT where there are both U.S. and third country shareholders of the U.K. corporation. The Treasury Department promulgated rules as part of its technical explanation of the Treaty ("Technical Explanation")[55] to deal with this problem. Significantly, these rules *exclude from the term "accumulated profits" profits of the U.K. corporation that would otherwise be included under U.S. tax concepts.*

According to the Technical Explanation of Article 23 of the Treaty, where a U.S. corporation owns less than all of the stock of a U.K. corporation, the section 902 credit must be calculated

> with reference solely to the proportionate interest in accumulated profits attributable to the United States shareholder. Thus, for example, the ratio which the distribution to the United States shareholder bears to accumulated profits in excess of income taxes . . . will be calculated as if the United States shareholder's proportionate interest in accumulated profits were the entire accumulated profits of a corporation of which it was the sole owner.

The Technical Explanation then provides an example involving a 25 percent U.S. corporate shareholder, and uses as "accumulated profits" in the section 902 formula *not* the entire $400 of the U.K. corporation's profits, but rather the U.S. shareholder's proportionate interest in those pretax profits—$100. The example concludes:

> Quite often the shares of a United Kingdom corporation are owned by both United States and foreign shareholders. In these cases, payment of

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[55] Amended Treasury Department Technical Explanation of U.S.-U.K. Income Tax Treaty (October 25, 1979), *reprinted in* III Tax Treaties (PH) ¶ 89,064.

an ACT credit to the United States shareholders will require a separate computation of earnings and profits for United States tax purposes which reflects that shareholder's proportionate interest in the corporation.

Thus, the Technical Explanation modifies the term "accumulated profits" to take into account properly the operation and effect of foreign tax law, and to avoid the "skewed result" that would follow from the rigid application of U.S. tax concepts advocated in the instant case. Moreover, since the Treaty is silent on this point, there can be no question that this solution flows from an interpretation of the statutory language of section 902. Simply put, if the stated rationale of Rev. Rul. 87-14 were correct, there would be no grounds to support the positions taken in either the Technical Explanation or the section 904 regulations.

III. PETITIONER IS WRONG IN ARGUING THAT THE COURTS, OR INDEED CONGRESS AND TREASURY, ARE INCAPABLE OF PROPERLY TAKING INTO ACCOUNT FOREIGN LAW WHEN NECESSARY TO PREVENT DOUBLE TAXATION.

Petitioner argues that taking into account foreign law in determining the indirect foreign tax credit would expose such determinations to the "vagaries of foreign tax law," requiring the courts to apply "unfamiliar [foreign] tax principles" that may be "difficult to ascertain" and "profoundly different" from U.S. tax laws. In Petitioner's view, "burdensome litigation" would result, jeopardizing the "fair administration" of the indirect credit; the inability of U.S. courts to determine foreign law would cause "troublesome and unwarranted interference with the proper administration of the statute." This chamber of horrors, according to Petitioner, can be laid at the feet of those courts which, like the Court of Appeals below, would ignore the "teaching" of *Biddle*.[56] Apparently, Petitioner mistakenly believes

[56] Pet. Br. at 40-41 & n.18.

that the "teaching" of *Biddle* is to disregard foreign tax law.

Petitioner's invitation to concede judicial incapacity where foreign tax law is concerned should be rejected summarily. This Court in *Biddle* did take foreign tax law into account to determine that a U.S. shareholder was not the person who "paid" the foreign tax. When, "by express language or necessary implication,"[57] the courts have been called on to take into consideration foreign tax law so as to mesh it with U.S. law, the courts have not hesitated to do so. This has often occurred in the foreign tax credit area.

Petitioner has stressed that the foregoing problems are "compounded" where the tax laws of several foreign jurisdictions are involved.[58] But in *Bank of America National Trust and Savings Association v. United States*,[59] the Court of Claims considered whether certain taxes that the taxpayer paid in Argentina, the Philippines and Thailand were income taxes and thus creditable under the foreign tax credit provisions. The court measured the substantive provisions of the respective foreign tax laws against the established benchmark of "United States concepts" of "income taxes."[60] The Court of Claims did not hesitate to

[57] *Biddle v. Commissioner*, 302 U.S. at 578.

[58] Pet. Br. at 41 n.18.

[59] 198 Ct. Cl. 263, 459 F.2d 513 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 949 (1972).

[60] The court noted the "consensus" that "the United States notion of income taxes furnishes the controlling guide," in that under established precedent, "the question of whether a foreign tax is an 'income tax' within § 901(b)(1) must be decided under criteria established by our revenue laws and court decisions, and . . . the foreign tax must be the substantial equivalent of an income tax as that term is understood in the United States." *Bank of Am. Nat'l Trust and Sav. Ass'n*, 459 F.2d at 515, 517. Thus, the Court of Claims, avoiding a blind application of an overbroad or universal rule of "United States law" or "foreign law" to the notion of "creditability," carefully measured and analyzed the substantive provisions of the foreign tax laws, in light of a specific, judicially-identified guideline. *See Bank of Am. Nat'l Trust and Sav.*

receive evidence on the provisions of multiple foreign tax laws in that case, and, indeed, such task cannot be avoided in determining whether a foreign tax is an "income tax" for purposes of the foreign tax credit.[61]

Courts have also considered foreign law in determining, with respect to the credit for foreign taxes, whether the taxpayer is legally liable under foreign law for the tax.[62] In *Nissho Iwai American Corporation v. Commissioner*,[63] the taxpayer claimed a credit for certain Brazilian withholding taxes on interest. The Tax Court noted that "[a] foreign tax is creditable only if the taxpayer is legally liable under foreign law for the tax." Accordingly, the court reviewed translations of the applicable Brazilian tax law and found that the taxpayer was legally liable under Brazilian law for the Brazilian withholding tax.[64]

Ass'n, 459 F.2d at 517-518; *compare Goodyear Tire & Rubber Co.*, 14 Cl. Ct. at 28.

[61] Courts have frequently ascertained foreign tax law for this purpose, including the laws of many diverse countries. *See, e.g., Bank of Am. Nat'l Trust and Sav. Ass'n.*, 61 T.C. 752, 755-759 (1974), *aff'd unpublished opinion* (9th Cir. Feb. 25, 1976) (Thailand); *Morrison-Knudsen Co., Inc. v. United States*, 68-2 U.S.T.C. ¶ 9612 (N.D. Cal. 1968) (Afghanistan); *Abbot Laboratories Int'l Co. v. United States*, 160 F. Supp. 321 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959) (Colombia); *Guantanamo & W. R.R. Co. v. Commissioner*, 31 T.C. 842 (1959), *acq.*, 1959-2 C.B. 4 (Cuba); *New York & Honduras Rosario Mining Co. v. Commissioner*, 168 F.2d 745 (2d Cir. 1948) (Honduras); *Chicago Burlington & Quincy R.R. Co. v. United States*, 197 Ct. Cl. 264, 455 F.2d 993 (Ct. Cl. 1972), *rev'd*, 412 U.S. 401 (1973) (subsequent history omitted) (Mexico); *Brantman v. United States*, 167 F. Supp. 885 (N.D. Calif. 1958) (Singapore).

[62] *Nissho Iwai Am. Corp. v. Commissioner*, 89 T.C. 765, 773 (1987); *Continental Illinois Corp. v. Commissioner*, T.C. Memo. 1988-318, 55 T.C.M. (CCH) 1325, 1330 (1988). Indeed, Petitioner's own Treasury regulations reflect the standard of legal liability that appears in case law and rulings, that the person considered as paying or accruing a foreign tax for purposes of sections 901 and 903 is "the person on whom foreign law imposes legal liability for such tax." Treas. Reg. § 1.901-2(f)(1).

[63] 89 T.C. 765 (1987).

[64] 89 T.C. at 773-774. Thus, the court effectively meshed the requisite

Similarly, in *Burns v. Commissioner*,[65] various partners claimed credits for certain British and Canadian taxes that had been accrued in respect of their partnership. The court examined provisions of British law to determine whether the British taxes were obligations of a partnership, or of the individual partners. Further, in *Gleason Works v. Commissioner*,[66] the Tax Court considered the peculiarities of the British tax system in relation to certain interest payments, and held that the creditor was entitled to the credit because the foreign tax fell in substance upon the creditor's income.[67]

Even the Commissioner, in his own Treasury Regulations, has required foreign law to be taken into account in determining whether the requirements are met for the creditability of a foreign tax.[68] Indeed, the Treasury Reg-

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foreign tax law considerations for determining the legal liability for tax, with the more general benchmark of "U.S. tax law" as the "standard" for deciding whether a foreign levy is a "creditable income tax."

[65] 12 B.T.A. 1209 (1928), *acq.*, VII-2 C.B. 3, 6.

[66] 58 T.C. 464 (1972).

[67] Indeed, *Gleason Works* followed several cases, including *Biddle, supra*, in which courts examined British law to resolve the foreign tax credit issues. *See, e.g., Trico Products Corp. v. Commissioner*, 46 B.T.A. 346 (1942); *Irving Air Chute Co. v. Commissioner*, 1 T.C. 880 (1943), *aff'd*, 143 F.2d 256 (2d Cir. 1944).

[68] Treas. Reg. § 1.901-2(b)(2)(ii) (foreign corporation considered to meet the realization requirement if the tax is imposed with respect to deemed distributions of amounts that meet the requirement in the hands of the person that, under foreign law, is deemed to distribute the amount); Treas. Reg. § 1.901-2(b)(4)(i) and (ii) (principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Code); Treas. Reg. § 1.901-2(e)(4)(i) (foreign law considered in determining whether a taxpayer's tentative "first levy" liability is or can be reduced by a "second levy" liability); Treas. Reg. § 1.901-3 (in connection with determining the amount of tax on foreign mineral income, such income is to be reduced by any credits, expenses, losses, and other deductions which are properly allocable to such income under the law of the foreign country); Treas. Reg. § 1.901-2A(e)(2) (for purposes of a safe harbor formula, gross receipts and costs and expenses are those determined under applicable foreign law); Treas. Reg. § 1.901-2(e)(5)(i) (amounts

ulations under section 904 mandate that foreign law be taken into account with respect to: (i) determinations of the source of income from certain foreign qualified business units ("QBU");[69] (ii) the effect on the limitation of reductions of foreign tax rates on distributions of income;[70] (iii) certain allocations of taxes to separate categories of income;[71] and (iv) the apportionment of foreign taxes that relate to more than one separate category of income.[72]

In summary, foreign law considerations necessarily occupy a significant place in our federal tax laws, and particularly as regards the foreign tax credit. The legislative histories of successive variations of the foreign tax credit provisions reveal consistent and unequivocal Congressional recognition of this fact.[73] Congress, the courts, and even

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paid are not compulsory payments, and thus are not amounts of tax paid, to the extent they exceed the amounts of tax liability under foreign law) (amounts paid do not exceed the amount under foreign law, if the taxpayer determines the amount consistently with reasonable interpretations and applications of the substantive and procedural provisions of foreign law); Treas. Reg. § 1.901-2(f)(3) (taxes paid are allocated based on the tax attributable to each spouse's share of the tax base under foreign law); Temp. Treas. Reg. § 1.905-3T(b)(1) (determinations of accrued and unpaid foreign tax liabilities denominated in foreign currency, as determined under foreign law).

[69] Treas. Reg. § 1.904-4(c)(4)(iii) (income determined to be from sources within or without the QBU's country of operation under the laws of the foreign country of the income payor).

[70] Treas. Reg. § 1.904-4(c)(7)(i) and (ii) (effective rate of tax imposed on a foreign corporation's income is reduced under foreign law upon distributing such income).

[71] Treas. Reg. § 1.904-6(a)(1)(i) (if foreign law exempts certain types of income from foreign taxes, then no taxes are "related" to the separate category).

[72] Treas. Reg. § 1.904-6(a)(1)(ii) (for purposes of apportioning foreign taxes among separate categories, gross income is determined under the law of the foreign country or United States possession to which the foreign income taxes were paid or accrued).

[73] For example, in connection with revisions to the foreign tax credit in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No.

Petitioner have seen fit to incorporate, analyze, and apply foreign laws within the federal scheme of taxation. Accordingly, this Court must summarily reject Petitioner's misguided plea for a mandatory, judicially-imposed exclusionary rule with respect to foreign law.

CONCLUSION

For the foregoing reasons, this Court should not hold, as Petitioner urges, that foreign tax law may *never* be taken into account in determining what constitutes "accumulated profits" for purposes of the section 902 indirect foreign tax credit. Rather, this Court, in its holding in this case, should recognize that foreign tax law must be taken into account to achieve Congress' purpose in enacting the indirect foreign tax credit, that is, *to prevent double taxation.*

Respectfully submitted,

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September 5, 1989

97-248, 96 Stat. 324, Congress stated:

> In determining the amount of taxes which are creditable, the Secretary would take into account the deemed foreign law deduction . . . .

S. Rep. No. 404, 97th Cong., 2d Sess. 1523 (1988). For additional examples, see Staff, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* 853-854 (J. Comm. Print 1987).

No. 88-1474 (7)

In The

Supreme Court of the United States

October Term, 1989

United States of America,

Petitioner,

v.

The Goodyear Tire & Rubber Company and Affiliates,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF FOR AMICUS CURIAE NATIONAL FOREIGN TRADE COUNCIL, INC.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

No. 88-1474

UNITED STATES OF AMERICA

Petitioner,

v.

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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BRIEF FOR AMICUS CURIAE NATIONAL FOREIGN TRADE COUNCIL, INC.

With the consent of the parties, as evidenced by letters on file with the Clerk, the National Foreign Trade Council, Inc., submits this brief amicus curiae in support of the position of the respondent Goodyear.

INTEREST OF THE AMICUS CURIAE

The amicus curiae National Foreign Trade Council, Inc., is a trade association established in 1914 consisting of more than 400 constituents engaged in all aspects of international investments, operations and trade. Many of the NFTC members are United States corporations with subsidiaries or branches in foreign countries. The NFTC constituents therefore are vitally concerned with the issue that this case presents of the meaning of Section 902 of the Internal Revenue Code.

STATEMENT

The Goodyear Tire & Rubber Company, together with its domestic affiliates that file a consolidated federal income tax return with it, is the respondent here. Goodyear has another subsidiary, The Goodyear Tyre & Rubber Company (Great Britain), Ltd. By law that subsidiary, Goodyear UK, as a foreign corporation, is not allowed to join in the consolidated return. However, when Goodyear receives dividends from Goodyear UK and pays United States income tax on them, it is entitled to a credit for any foreign income tax paid on profits related to the dividends. That credit is granted to prevent double taxation.

The case concerns the extent of Goodyear's deemed-paid credit under Section 902(a)(1) of the Internal Revenue Code ("deemed-paid" because the United States taxpayer does not directly pay the foreign tax) for 1970 and 1971. The British tax authorities allowed Goodyear UK deductions in 1973 that produced a loss in that year. When carried back to 1971 (1972 was already a loss year), the 1973 loss wiped out all the profits on which Goodyear UK had paid a British income tax in that year and therefore all the tax. What was left of the 1973 loss was carried back farther to 1970 and wiped out all but a little of the profit and the tax of that year.

As a consequence of the loss carryback, Goodyear recomputed its foreign taxes deemed paid with respect to the dividends it received from Goodyear UK by associating those dividends with profits that Great Britain had already accounted for and taxed, *i.e.*, profits realized in earlier years. The Internal Revenue Service, on the other hand, proposed to associate the dividends with the profits that Goodyear UK originally reported for 1970 and 1971. The reason for this treatment, it said, was that it would not have recognized in 1973, for a United States corporation paying United States income tax, the British deductions that caused the 1973 loss that all but eliminated Goodyear UK's 1970 and 1971 profits. When the constructive profits

of 1970 and 1971 generated by this proposed application of United States tax law to a foreign operation were associated with the minimal tax actually paid under the foreign tax law that determined the tax, the result under the statutory formula for computing the deemed-paid tax credit was a very small credit.

The different computations of the deemed-paid credit produced a difference of more than half a million dollars in Goodyear's tax liability. Goodyear paid the deficiency that the Service asserted and sued in the Claims Court for a refund. The Claims Court decided for the Government. On appeal, the Court of Appeals for the Federal Circuit held that foreign law governed, as Goodyear asserted, and reversed.

SUMMARY OF ARGUMENT

The issue in this case is the meaning of the term "accumulated profits" as used in Section 902(a)(1) of the Internal Revenue Code as the section read before it was substantially revised in 1986. Accumulated profits are a principal element in a statutory formula that Section 902(a)(1) prescribes for relating a dividend that a United States shareholder receives in one taxable year to the profits a foreign corporation earns over a course of years. This determination dictates how much credit the shareholder, as a United States income taxpayer, receives for foreign income taxes imposed with respect to the profits that made possible the payment of a taxable dividend by a foreign corporation in which it has an interest.

1. Textual and contextual analysis demonstrates that a foreign corporation's accumulated profits, statutorily defined as its "gains, profits, or income," are to be determined according to the foreign tax law that governs the amount of the foreign tax that—in the words of the statute—is paid or imposed "on or with respect to" such gains, profits or income. That meaning of accumulated profits is confirmed by the statutory history of the deemed-paid tax credit, which this Court considered in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942).

2. Only if accumulated profits are measured according to foreign tax law rules does Section 902(a)(1) fulfill its purposes of (a) preventing double taxation; (b) ensuring that the deemed-paid tax credit properly reflects the actual foreign tax borne by the income used to pay the dividends received by and taxed to the United States corporate parent; and (c) ensuring equitable treatment of United States taxpaying corporations that operate abroad through branches, on the one hand, and through subsidiaries on the other. When foreign tax rules are used, those purposes are served and there is no risk of a windfall for the United States taxpayer or harm to the Treasury.

3. Neither administrative nor judicial precedent argues for the Government's position that accumulated profits are determined by the application of United States tax rules, a position that cannot claim a solid source even in the regulations to which the Government asks this Court to defer.

ARGUMENT

Those who pay a United States income tax receive a credit for any foreign income tax they have paid on the same income. I.R.C. §§ 33, 901 (1970) (Gov't Br. la). Section 902 of the Code (Gov't Br. 2a-4a) affords an equivalent credit to a United States corporation that is the parent of or has an interest of as little as 10 percent in a foreign corporation that pays it a dividend.[1] The credit in that case is for foreign tax that the United States corporate taxpayer has not in fact paid but is "deemed to have paid" because the tax was paid by the foreign dividend payor on or with respect to the profits that made possible the payment of the dividend. The deemed-paid credit has the same purpose as the credit for foreign income taxes paid directly: the avoidance of double taxation.

[1] Section 902(a)(1) as it appears in the appendix to the Government's brief is the statute as it read in the tax years 1970 and 1971, with which this case deals. The Federal Circuit in its opinion (Pet. 4a) quoted the statute as it read just before it was revised in 1986. Our references to and descriptions of Section 902 will generally be to and of the 1970-71 version. As the Court knows from the presentations of the parties, Section 902 was thoroughly revised in 1986 for tax years beginning after December 31, 1986.

When a wholly owned foreign subsidiary pays out as a dividend in a year all of the annual profits left after it has paid its foreign income tax, its United States parent is entitled to a deemed-paid credit for the full amount of the foreign income tax paid. If, however, a foreign corporation is less than wholly owned or if a wholly owned subsidiary in a particular year distributes only a part of what is available after payment of the foreign tax, the credit should obviously not be for the full amount of the foreign tax. There has to be a way of determining how much of the foreign tax paid in a year should be attributed to the dividend received by the United States corporation in that year (and, over time, to dividends received in subsequent years that are paid out of any income retained in the first year). As the parenthetical addition to the last sentence suggests, there may also be years in which a subsidiary's dividend to a parent exceeds its profits for the year of the dividend. To ensure a full credit, there has to be a way of tracing that dividend or a part of it back to the tax paid when the retained income now being distributed was earned.

Congress prescribed in Section 902(a)(1) a formula for computing the credit. Featuring the concept of accumulated profits, the formula permits the apportionment of the foreign tax paid in any year and the tracing, or sourcing, of dividends to the years of the profits that made them possible. According to the formula, the tax credit (C) is equal to the total foreign income tax paid by the foreign dividend payor (T) times the dividend (D) divided by the payor's accumulated profits (P) minus the total foreign tax (again T). Thus, $C = T(D/(P-T))$.

The issue in this case is the meaning of accumulated profits. The court below held that "the plain meaning of the statute" is that these are profits determined according to the foreign nation's tax laws. (Pet. 6a.) The Government

calls this conclusion "counterintuitive" (Gov't Br. 14) even though the section of the Code we are concerned with deals with a foreign corporation paying a foreign tax under foreign law. The Government proposes a definition that, as shown by its proposed treatment of Goodyear UK, makes the size of a foreign corporation's profits on which a foreign tax is paid a function of United States tax law.

In what follows we shall urge that the court of appeals' reading of Section 902 is the correct reading—the reading that is required by its text and context, accords with its history, and best carries out the policy of the section—and that, contrary to the Government's arguments, no administrative practice or precedent requires a different reading.

I. THE TEXT AND CONTEXT OF SECTION 902(a)(1) REQUIRE THAT ACCUMULATED PROFITS OF A FOREIGN CORPORATION ARE DETERMINED BY FOREIGN TAX LAW.

A. A Straightforward Reading of Section 902(a)(1) Is That a Foreign Corporation's Accumulated Profits Are Its Profits Determined According to the Law of the Foreign State Taxing Them.

Section 902(a)(1) says that "a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall . . . be deemed to have paid the same proportion of" income taxes paid by the foreign corporation to a foreign country "on or with respect to . . . accumulated profits," as defined in Section 902(c)(1)(A) that the amount of the dividends "bears to the amount of such accumulated profits" minus the income taxes paid. Section 902(c)(1)(A) (Gov't Br. 3a-4a) defines accumulated profits, for purposes of Section 902(a)(1), as a foreign corporation's "gains, profits, or income" without reduction for the amount of any income "taxes imposed on or with respect to such profits or income" by a foreign country.

Thus, on the face of Sections 902(a)(1) and 902(c)(1)(A), accumulated profits and their definitional equivalent, gains, profits or income, are something on or with respect to

which a foreign income tax is paid or imposed. The foreign tax is the beginning point in Section 902(a)(1). It is an amount over which United States taxing authorities and United States tax law have no control. The foreign tax is a percentage of the foreign tax base, the corporation's net income or profits. In that way the foreign tax is—using the words of Section 902—"imposed" or "paid" "on or with respect to" the tax base. The foreign tax base is, we submit, what Section 902(a)(1) calls "accumulated profits" and Section 902(c)(1)(A), in turn, refers to as "gains, profits, or income." United States tax law is as extraneous to the determination of accumulated profits or gains, profits or income so understood as it is to the determination of the tax that is paid or imposed on or with respect to the accumulated profits or gains, profits or income.

There is no reason to believe, and every reason not to believe—it is counterintuitive, shall we say—that Congress meant accumulated profits, a phrase used only in respect of foreign corporations and their foreign taxes, to refer to gains, profits or income measured according to the rules of United States tax law. Yet this is precisely what the Government advocates: an extraterritorial application of United States tax law to define items of gross income and allowable deductions of a foreign corporation and assign them to particular tax years, thereby constructing an artificial tax base that is not the base for the actual foreign tax. To the extent that United States tax law defines items of gross income and allowable deductions differently from foreign tax law or assigns them to different years from those to which foreign law assigns them, the amount so determined at times will be greater and at times less than the amounts "on or with respect to" which the foreign tax was imposed. The foreign tax paid by the foreign corporation thus will not match the corporation's gains, profits or income, and neither will the credit, as the statute contemplates that it should.

B. The Government's Reading of Section 902(a)(1) Is Not Supported by the Text of the Section.

Precisely what concept in United States tax law the Government believes that "accumulated profits" are the equivalent of is not clear. Below, the Government seemed to urge that a foreign corporation's "accumulated profits" were or approximated what its taxable income would have been if determined according to United States law. (*See* J.A. 21, ¶ 7 of stipulation). That position at least had the virtue that taxable income, like accumulated profits, is a pre-tax figure and, like accumulated profits (*see* Gov't Br. 4 n.4, 17 n.6, 25 n.11), is an annual figure. But that position has the fatal flaw of lacking any foundation whatever in the text of Section 902. It is, moreover, irreconcilable with the statutory reporting provision associated with Section 902. I.R.C. § 6038(a)(1)(B) (p. 12, *infra*.). The Government does not press the argument here, presumably because of its indefensibility, although there remain traces of it in the brief. Instead, the Government now seems to turn to United States "earnings and profits" as the claimed equivalent of accumulated profits, although here too its position is vague and fuzzy. It typically uses such uncertain phrases as "defined under principles of United States taxation" (Gov't Br. 32) or "determined by United States law" (*id.* at 33).

While thus eschewing precisely to equate a foreign corporation's accumulated profits with United States earnings and profits, the Government draws heavily in its argument on the fact that Section 902(a)(1) uses the term "dividends" and refers to dividends' being paid out of "accumulated profits." (Gov't Br. 3, 18, 42-43.) Dividend is a term of art in United States tax law. A dividend is a corporate distribution that is paid out of a corporation's earnings and profits. I.R.C. § 316.

But it does not follow, as the Government contends, that, because statutory dividends can be paid only out of earnings and profits, accumulated profits in Section 902(a)(1) must mean United States earnings and profits or

something that "should accord with" (Gov't Br. 12) United States earnings and profits. To the contrary, the two terms cannot rationally be equated. In the first place, though this is not conclusive, earnings and profits by their nature are an *after*-tax concept: they are the amount available for the payment of dividends. On the other hand, accumulated profits in Section 902(a)(1) are, by the Section 902(c)(1)(A) definition, a *before*-tax amount.[2]

Furthermore, earnings and profits generally are cumulative; there is a concept of annual earnings and profits, but earnings and profits most commonly designate the amount left in a corporation's surplus at any time as a result of the profits realized and losses incurred and income taxes and dividends paid over time. Accumulated profits—despite their name—"are computed on a year-by-year basis," which distinguishes them from earnings and profits, as the Government quietly acknowledges (Gov't Br. 25 n.11). *See General Foods Corp.* v. *Commissioner*, 4 T.C. 209 (1944), *acq.* 1946-1 C.B. 2.

Finally, earnings and profits—even a particular year's earnings and profits—are not an amount that an annual income tax is paid or imposed "on or with respect to." A year's earnings and profits before taxes (which is really a contradiction in terms) are not simply the equivalent of a year's corporate taxable income. As an elementary example, a corporation might own tax-free municipal bonds, the interest on which would enter into its earnings and

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[2] It is true that in the predecessor to Section 902(a)(1) construed in American Chicle Co. v. United States, 316 U.S. 450 (1942), and, indeed, all predecessors up to 1962, accumulated profits were after-tax profits. And there is no indication that it was thought that the basic concept of accumulated profits was changed by the 1962 amendment, 76 Stat. 960, 999-1001. *See* H.H. Robertson Co. v. Commissioner, 59 T.C. 53, 78 (1972), *aff'd*, 500 F.2d 1399 (3d Cir. 1974). Given the inconsistency of the post-1962 wording of Section 902(a)(1) with an equation of accumulated profits and earnings and profits, that can only mean that the pre-1962 predecessors could not have meant earnings and profits when they said accumulated profits, and Congress so understood when it acted in 1962.

profits as a legitimate source of dividends but not of course into its taxable income. Section 312 of the Code sets out a long catalogue of factors that enter into the computation of earnings and profits and differ from the factors pertinent to calculating annual taxable income.

All the uses of the phrase "accumulated profits" in Section 902(a)(1) can be harmonized, however, as the Government's reading of the section, emphasizing the payment of dividends "out of" accumulated profits, does not. The first proposition is that the phrase describes, foremost, the amount on or with respect to which the foreign taxes are paid. The next proposition is that the unqualified term "dividends" in the introductory paragraph of Section 902(a)(1) by itself amply demonstrates that the amount against which a credit may be allowed is a distribution to the United States parent from earnings and profits; no reference to accumulated profits is necessary to that conclusion. The further point is that a dividend, already defined as a distribution out of earnings and profits, is also paid out of or from the gains, profits or income of the foreign corporation as measured by foreign law. Congress thus used the concept of accumulated profits for a purpose quite other than limiting the application of Section 902(a)(1) to United States taxable dividends. It used accumulated profits in describing the temporal relationship of the dividend to the corporation's gains, profits or income in order to enable the United States taxpayer to trace the source of a dividend, as appropriate, to a year or years in which a foreign tax was paid on the accumulated profits that support the dividend.

C. Contrasting Use in Other Provisions of the Code and Other Contextual Evidence Reinforce the Plain Meaning of the Term Accumulated Profits in Section 902(a)(1).

When Congress wants to specify the use by taxpayers of earnings and profits of foreign corporations, measured as nearly as possible according to United States law, it says so. It has said so in Subpart F of the Code, added

in 1962.[3] That series of sections provides for the imputation to a United States shareholder of certain income of a United States-controlled foreign corporation without the necessity of any dividend actually being paid. Because Subpart F in effect treats dividends as paid even though they have not been paid, Section 952(c) of the Code provides that the income that is imputed, known as Subpart F income, may not "exceed the earnings and profits of" a controlled foreign corporation for a taxable year.

Correspondingly, another provision of Subpart F, Section 960, as it read in the tax years in issue here, established a formula, similar to the formula of Section 902(a)(1), for computing a deemed-paid tax credit for foreign income tax paid on or with respect to any part of a foreign controlled corporation's earnings and profits imputed to a domestic corporation. In Section 964, yet another Subpart F provision, Congress recognized the difficulty of calculating the earnings and profits of a foreign corporation, and provided that, for the purposes of Subpart F, earnings and profits should be "determined according to rules substantially similar to those applicable to domestic corporations" set forth in regulations. There is no such recognition of problems of calculation in Section 902 because the use of earnings and profits (except to ascertain in the first instance whether a distribution is a dividend) is not contemplated.[4]

Adding to the contextual significance of the striking dissimilarity of the words Congress chose for Section 902,

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[3] Subpart F of Part III, Chapter 1N, Subtitle A, Internal Revenue Code. I.R.C. §§ 951-64.

[4] There is usually leeway in a foreign corporation's surplus account, however computed, for paying a dividend, so that the need to compute its United States earnings and profits to ascertain whether a distribution is a dividend to its United States parent is more theoretical than burdensome. On the other hand, a year-by-year calculation of a foreign corporation's United States earnings and profits to work the Section 902(a)(1) formula could be very burdensome, requiring calculations not required for any other business, taxation or regulatory purpose.

on the one hand, and Section 960 on the other is the fact that, when Subpart F was added to the Code in 1962, Section 902 was substantively amended (P. 9 n. 2, *supra*), but its wording was not made to conform with that of the new and parallel Section 960 formula for computing a deemed-paid tax credit. Congress, while using "earnings and profits" in the new provision, stayed with "accumulated profits" in the existing provision it was amending—a singular decision if the two phrases were intended to be synonymous.

There is one final piece of compelling contextual evidence that Congress did not mean that accumulated profits should be calculated according to United States tax standards. Section 6038(a)(1)(B) of the Code requires a United States person controlling a foreign corporation to furnish the IRS with certain information regarding the subsidiary. Until the law was changed in 1986, one of the items that had to be submitted was a statement showing

> "the accumulated profits (as defined in section 902(c)) of such foreign corporation or foreign subsidiary, including the items of income (*whether or not included in gross income under Chapter 1*), deductions (*whether or not allowed in computing taxable income under Chapter 1*), and any other items taken into account in computing such accumulated profits." (Emphasis added.)

Obviously, if Congress had thought that accumulated profits meant taxable income calculated according to United States tax law, it would not have used the italicized phrases. If it had meant that accumulated profits should equal earnings and profits, it would have said that and probably referred to the Section 312 catalogue of items that differentiate earnings and profits from taxable income. What it did mean was that accumulated profits were defined by foreign standards.

D. The History of Section 902(a)(1) Confirms the Reading Demanded by Its Text and Context.

The history of Section 902 confirms the reading of the section demanded by its text and context. The "deemed-paid" credit for foreign taxes entered the tax code in 1918 at the same time as the foreign tax credit itself. The formula set forth in Section 240(c) of the Revenue Act of 1918, 40 Stat. 1082, the forebear of the Section 902(a)(1) formula, was more rudimentary. The credit was for the proportion of foreign income taxes that "the amount of any dividends" received by the domestic parent corporation from the foreign subsidiary bore "to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid." The Court of Appeals for the Second Circuit was to say that it seemed "entirely clear" that "the words, 'the total taxable income * * * upon * * * which such taxes were paid', means the sum used by the foreign government as a base to compute the foreign tax." *United Dyewood Corp.* v. *Bowers*, 56 F.2d 603 (2d Cir. 1932). It has to be "entirely clear" to anyone who reads the words: a foreign corporation's "total taxable income" is not determined according to the tax laws of the United States.

In the Revenue Act of 1921 the deemed-paid credit was significantly changed, for the reason explained in *American Chicle Co.* v. *United States*, 316 U.S. 450, 453-54 (1942). The Court said that the difficulty with the original 1918 version of the deemed-paid credit was that it did not allow for matching the tax paid with the dividends received: "if dividends were paid out of surplus earned in prior years, and it happened that the subsidiary paid no tax to the foreign country in the year in question [when dividends were paid], the parent could claim no credit whatever." *Id.* at 453. The changes made in 1921 permitted "identification of the accumulated profits of each taxable year out of which the dividends might have been paid" and thus the giving of "credit for a proportion of the subsidiary's taxes attributable to such accumulated profits." *Id.* at 454.

Thus, Section 238(e) of the Revenue Act of 1921, 42 Stat. 259, introduced the term "accumulated profits" in order to permit the "sourcing" of dividends paid in year X to the profits of a previous year A, B or C when a foreign tax was paid. "Accumulated profits" continued to be related, in just the same way "total taxable income" had been, to the foreign income taxes for which credit was to be given; they were what the foreign taxes were "paid . . . upon or with respect to." The term accumulated profits was defined substantially as it is in Section 902(c)(1)(A) (except that accumulated profits initially denoted an after-tax amount, see P. 9 n. 2, *supra*). It was defined as the amount of the foreign corporation's "gains, profits, or income in excess of the income . . . taxes imposed upon or with respect to such profits or income."

The change effected in 1921 was a major one. But there is no hint that Congress, in making the change, meant that accumulated profits, unlike the predecessor "total taxable income," were to be calculated by the application of United States tax laws and not foreign tax laws. Indeed, this Court said in *American Chicle* that "'accumulated profits,' . . . by definition, are [the foreign subsidiary's] total taxable profits less taxes paid." 316 U.S. at 452. "Total taxable profits" is close to "total taxable income," the 1918 statutory term, and that, as the Second Circuit said, was "the sum used by the foreign government as a base to compute the foreign tax." 56 F.2d at 603. At no later stage in the history of reenactments and amendments that produced the version of Section 902(a)(1) applicable in 1970 and 1971 is there a suggestion that accumulated profits meant not a foreign corporation's foreign tax base but its income or profits artificially determined according to United States tax rules.

II. ONLY THE DETERMINATION OF ACCUMULATED PROFITS BY FOREIGN TAX RULES ENABLES SECTION 902(a)(1) TO SERVE ITS PURPOSES.

At the most general level, the purpose of Section 902 is to prevent double taxation. More specifically, Section 902(a)(1) has the purpose of ensuring that the deemed-paid credit is for an amount that reasonably reflects the foreign tax borne by the income used to pay to the dividend and, thereby—a third and final purpose on which the Government lays great stress (Gov't Br. 26-32)—making the United States income-tax treatment of a domestic corporation that owns or has an interest in a foreign corporation as nearly as possible the same as that of a domestic corporation that operates overseas and pays income taxes directly to a foreign country.

The Government says that only if the accumulated profits of the Section 902(a)(1) formula are measured according to United States standards will these purposes be achieved. To the contrary, it is demonstrable that the purposes are achieved only if "accumulated profits" are determined by applying foreign tax standards.

A. If Accumulated Profits Are Not Determined by Foreign Tax Law Standards, Double Taxation May Result.

Determining accumulated profits by United States tax rules does not reliably prevent double taxation; using foreign tax rules to determine accumulated profits does. When United States tax rules are applied to measure the accumulated profits of a foreign subsidiary, a domestic corporation may be left without a deemed-paid tax credit even though it has received a dividend from the subsidiary, the dividend has been taxed by the United States, and the profits that yielded them have been taxed by the subsidiary's home country. That is the double taxation that Section 902(a)(1) is meant to prevent. There cannot be double taxation when the dividend-yielding, taxed profits are left as they were, defined by the foreign tax law.

The case that demonstrates that, when United States tax principles are applied, double taxation can occur is the typical case in which a difference between the application of United States tax rules and foreign tax rules to determine a foreign corporation's income makes a difference in a particular tax year. That is, it is a case in which the

timing of income or deductions differs depending on which rules are applied. In this respect, it resembles Goodyear's case. A major item giving rise to the dispute between Goodyear and the Government was an item of timing, explained in the margin.[5]

Suppose, then, that a foreign subsidiary shows the following income and foreign tax over three years:

TABLE I

	Year 1	Year 2	Year 3
Annual Accumulated Profits (Foreign)	0	$1000	0
Foreign Tax	0	300	0
After-Tax Income	0	$ 700	0

Suppose, further, that United States tax law would record the $1000 of income in Year 1 rather than in Year 2. For United States purposes, the foreign subsidiary's income would appear as follows:

[5] Britain allowed rapid depreciation of assets, which reduces a corporation's net taxable income in the early years of an asset's life, as it did for Goodyear UK in 1973, but increases it in later years. The same total amount of depreciation expense will be recognized over time under the slower United States depreciation rule. Net taxable income if summed over several years will be about the same in either country. In addition, though not so clearly a matter of timing, Britain permitted Goodyear UK to reduce the value of its year-end inventory by the increase in its value during the year less 10 percent of trading profit for the year. Under the British law at that time, there was a "clawback" provision so that, if the inventory dropped, the benefit of the inventory deduction would be lost.

TABLE II

	Year 1	Year 2	Year 3
Annual Accumulated Profits (U.S.)	$1000	0	0
Foreign Tax	0	($300)	0
After-Tax Income (Loss)	$1000	($300)	0

The foreign subsidiary has $700 available for payment to its parent as a dividend. The Government's contention that accumulated profits are measured according to United States rules would match this dividend, whenever it was paid, with *zero* foreign tax, the foreign tax that the corporation paid in Year 1, to which the Government would assign the $1000 of accumulated profit. Worse, the Government would match the $300 foreign tax paid in Year 2 with a *zero* amount of accumulated profits, so that this foreign tax would *never* be creditable. If the Government's approach were followed, the United States shareholder would obtain *no* foreign tax credit. The foreign tax would be trapped in a year without accumulated profits, by the Government's measurement of them, so that there could never be a credit for the tax. The phenomenon does not—cannot—occur when accumulated profits are measured by foreign standards. When that is done, the foreign tax and the accumulated profits are necessarily recorded in the same year, and the dividend, whenever paid, is related to accumulated profits of a year in which a foreign tax was paid to credit against the United States tax on the dividend.

Thus, when accumulated profits are computed according to United States tax rules, Section 902(a)(1) can and sometimes does fail its basic purpose of preventing double taxation. It also fails, as we shall next see, its more specific purposes of properly measuring the amount of tax attributable to the dividend and of treating the United States corporation with a foreign subsidiary like the United States corporation with a foreign branch.

B. Corrected and Expanded Versions of the Government's "Simple Examples" of the Workings of Section 902(a)(1) Show That Measurement of Accumulated Profits by Foreign Tax Rules Is Necessary to Achieve the Specific Purposes of the Section.

The Government attempts to explain the workings of the Section 902(a)(1) formula with "some simple examples." (Gov't Br. 4 n.3.) It uses these same examples to illustrate what it contends are the distortions produced by measuring accumulated profits according to foreign tax principles (*id.* at 21-22) and why measuring them according to United States tax principles is necessary to ensure equal treatment of the corporation that owns a foreign subsidiary and the corporation that operates a branch abroad (*id.* at 31-32). These "simple examples" illustrate nothing useful because they embody an elementary misstatement of what an income tax is. In the Government's examples the absolute amount of the foreign tax ($20) stays the same even as foreign taxable income rises from $100 to $180 and then dips to $60. No foreign income tax works that way. They are all percentage taxes, like the United States income tax. When the Government's mistake is corrected, the Government's examples illustrate our point, not its.

The Government begins with a base case in which accumulated profits are the same whether measured according to United States or foreign tax rules:

TABLE III

Accumulated Profits (Foreign & U.S.)	$100
Foreign Tax	20
Dividend	80

The foreign tax credit in this case is 20(80/(100-20)) or $20.

The Government then changes the base case, first to increase the amount of accumulated profits by foreign rules to $180 while such profits by United States rules remain at $100.

TABLE IV

Accumulated Profits (Foreign)	$180
Foreign Tax	20
Dividend	80

The foreign tax credit in this case, if foreign rules define the accumulated profits of the denominator of the Section 902(a)(1) fraction, is 20(80/(180-20)) or $10. But if, as the Government urges, that is too small a credit compared with the base case credit of $20, when United States-defined accumulated profits and the amount of the dividend are the same as in the base case, it is not because there is anything wrong with the use of the foreign-law based $180 as the accumulated profits of the denominator. It is because the foreign tax in this case would not have been $20 but, at the 20-percent rate implicit in the base case, $36 (20% x 180).

Corrected to retain the 20-percent tax rate and not the absolute tax of $20, this second case yields a foreign tax credit of 36(80/(180-36)) = $20. A credit of $20 matches the credit in the base case and is perfectly appropriate when United States earnings and profits (before tax) are $100, the foreign tax rate is 20 percent, and all the available profits are distributed as a dividend. We would add that, when the remaining accumulated profits of $64 were paid out, the distribution would not constitute a dividend and the remaining $16 of foreign tax, quite appropriately under the statute, would not result in any foreign tax credit.

The Government's second modification assumes accumulated profits measured by foreign rules of less than the $100 of the base case:

TABLE V

Accumulated Profits (Foreign)	$60
Foreign Tax	20
Dividend	40

The foreign tax credit is 20(40/(60-20)) = $20. The Government suggests that a credit of $20 is too high, because it equals the credit allowed in the base case, even though only half of the after-tax United States profits of $80 have been distributed as a dividend. But in fact that credit of $20 is due not to the determination of accumulated profits by foreign rules but to the increase in the foreign tax rate, from 20 to 33 percent, that the Government has, probably unwittingly, smuggled into its example. If that error is corrected, and the foreign tax rate of 20 percent is retained, the foreign tax becomes $12 (20% x 60). If, in addition, we assume as the Government seems to assume that all of the foreign-determined earnings after tax (and no more) are paid out as dividends, the dividend is $48 (60-12) and the foreign tax credit is then 12(48/(60-12)) or $12, which for reasons explained in the margin bears just the relationship to the $20 credit of the base case that it should.[6]

There is another flaw in the Government's series of examples. They are static, single-year examples. As can be understood from the *American Chicle* opinion, the very reason for the introduction of "accumulated profits" into the deemed-paid tax credit provision of the tax code was to account for the fact that dividends are often paid out

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[6] The foreign corporation in the base case distributed 100% of its after-tax profit (80 = 100 - 20) and obtained a foreign tax credit of $20. The Government suggests that a credit of $20 is too high in its second modification of the base case, where less than the full amount of earnings and profits are distributed. In the modification as we have corrected it, 60% of the base-case after-tax profits (48 = 60% x 80) are distributed so that the appropriate foreign tax credit relative to the base case is 60% of 20 (the base case credit) or $12.

in a year other than a year in which the profits supporting them were earned and taxed. (Pp. 13-14, *supra.*) A single-year example cannot take account of that phenomenon.

Moreover, unless one uses multi-year examples, one does not come to grips with the preponderant kind of issues whose resolution depends on whether accumulated profits are measured by United States or foreign tax principles—issues arising from differences in the year to which the law assigns income or deductions. The Government's one-year examples indeed do not come to grips with the issue in this case, where the Inland Revenue allowed Goodyear UK deductions earlier than the Internal Revenue Service would have allowed them to a United States taxpayer. (P. 16 n. 5, *supra*).

We can turn the Government's sterile one-year examples into a useful multi-year example by just a few modifications. We take the second variation of the Government's base case, where the foreign taxing jurisdiction allows a $40 deduction that the United States does not allow—presumably ever—and assume more realistically that the issue is one of timing. We assume that the deduction will be allowed by the United States but in a later year. We retain the same 20-percent foreign tax rate that the Government probably meant to assume, and we accept its assumption that the foreign subsidiary pays all its net income, after foreign income taxes, to the United States parent each year.

The multi-year example (which, mathematically, need only be a two-year example, Year 2 standing for any and all subsequent years) demonstrates that, if accumulated profits are measured by foreign tax rules, double taxation is prevented and the subsidiary purposes of Section 902(a)(1) are also served. The foreign tax credit is fairly proportional and is as near as inherent differences in the two ways of doing business permit to the credit that a United States corporation with a foreign branch would receive. The same things are not true if accumulated prof-

its are measured as the Government would measure them, according to United States rules.

The demonstration begins with the following table, which shows, up to the point of the tax credits, the results of varying the year in which a deduction is allowed.

TABLE VI

	Year 1	Year 2
Gross Income[7]	$100	$40
Deduction		
Foreign Timing	(40)	
U.S. Timing		(40)
Foreign Accumulated Profits	60	40
U.S. Accumulated Profits	100	0
Foreign Taxes	12	8
Dividend Paid	48	32

Before we compute the credit for foreign taxes paid by a subsidiary with these results, we note that the foreign tax credit of a United States taxpayer realizing results similar to these through a foreign branch would equal the foreign tax imposed in each year. The taxpayer might be subject to a limitation on the foreign tax credit in Year 2 because of the branch's failure to produce income taxable by United States standards, but the excess credit would be carried back to the first year. Assuming a United States income tax rate of 40 percent, the taxpayer's United States taxes from its foreign branch operations would be figured as follows:

[7] In the Government's base case the foreign subsidiary's net income, or accumulated profits, is $100 under the rules of either taxing regime. In this example we retain that premise but extend it over time by treating the $40 deduction of the Government's variation of the base case (assumed, for simplicity, to be the only deduction) as allowable by foreign rules in Year 1 and by U.S. rules in Year 2. There must therefore be $140 of gross income to yield $100 of total net income over two years under both regimes.

TABLE VII

	Year 1	Year 2
U.S. Taxable Income	$100	0
Tentative U.S. tax	40	0
Foreign Tax Credit (Year 1)	(12)	0
Foreign Tax Credit (Year 2 carryback)	(8)	0
Net U.S. Tax	$ 20	0

If foreign tax rules determine what accumulated profits amount to, then, over the two years of our example, the Section 902(a)(1) formula yields for the corporate parent of a foreign subsidiary that distributes its after-tax foreign profits in full each year a tax credit of $20, the same as the tax paid and the credit received by the United States corporation with a foreign branch. The credit in Year 1 is the foreign tax of $12 multiplied by a fraction consisting of the dividend of $48 over accumulated profits of $60 minus the foreign tax of $12; the fraction is 1 and the credit is for the full amount of the foreign tax, $12: 12(48/(60-12)) = 12. Similarly, in Year 2: 8(32/(40-8)) = 8, and again the credit is for the full amount of the tax, $8; finally, $12 + $8 = $20.

This is *not* true if United States tax rules govern the timing of the deduction. In that case Table VI shows accumulated profits of $100 in Year 1 and 0 in Year 2, and the formula yields:

Year 1: 12(48/(100-12)) = $6.55.

Year 2 (that year's dividend of $32 is assigned to the accumulated profits from Year 1):

12(32/(100-12)) = $4.36.

The credit over the two years ($10.91) is thus only a little more than half what it should be.

The point is driven home by a comparison of the total United States income tax burden of the corporate parent whose subsidiary's accumulated profits are determined according to (1) foreign law and (2) United States law.

TABLE VIII

(1) Foreign Law	Year 1	Year 2	Total
U.S. Taxable Income	$48	$32	
Gross-up for Foreign Taxes Paid[8]	12	8	
Tentative U.S. Tax @40%	24	16	
Foreign Tax Credit	12	8	
Net U.S. Tax	$12	$ 8	$20

(2) U.S. Law	Year 1	Year 2	Total
U.S. Taxable Income	$48.00	$32.00	
Gross-up for Foreign Taxes Paid	6.55	4.36	
Tentative U.S. Tax @40%	21.82	14.54	
Foreign Tax Credit	6.55	4.36	
Net U.S. Tax	$15.27	$10.18	$25.45

If accumulated profits are defined according to foreign law, the United States taxpayer receives the credit to which it is entitled and pays the United States tax, after credit, that it should. The only difference between the treatment of that taxpayer and the taxpayer with a foreign branch is a difference that is inherent in the choice to do business in one form or the other; sometimes the timing of the receipt of income and therefore of the tax credit will differ depending on the choice made. On the other hand, if accumulated profits are determined according to United States law, the taxpayer that does business through a subsidiary pays a wholly unwarranted penalty and suffers

[8] Grossing-up, the addition to United States income of the foreign income tax deemed paid by a dividend recipient, is explained by the Government at page 23 n.10 of its brief.

by comparison with the taxpayer that does business through a branch. It receives less of a credit over the two relevant years than it is entitled to, and it thereby suffers double taxation to the extent of the credit it loses. In our example, it pays a total tax of more than 45 percent of its income from the subsidiary instead of the maximum of 40 percent that it should have to pay.

There is no way of avoiding the logic of the example that shows this result. There will be comparable or different distortions whenever United States tax principles are used to determine the timing of income and deductions that are different from the foreign principles that determine the timing of the foreign tax. The tax will inevitably be divorced from the income on which it is imposed and the dividend that the income makes possible, and that inevitably will distort the amount of the credit. On the other hand, if foreign law determines accumulated profits, there will be no distortions or "windfalls," notwithstanding the Government's assertions to the contrary (Br. 45-46). This is so because the "deemed-paid" credit that can be claimed cannot exceed the amount of the foreign tax actually paid, and the credit cannot be allowed before the foreign tax is paid.

III. THE TREASURY REGULATION PURPORTING TO DEFINE ACCUMULATED PROFITS IS CONFUSED AND INCONSISTENT WITH THE STATUTE, AND THERE IS NO SETTLED JUDICIAL CONSTRUCTION OF THE PHRASE.

The Government cites the Treasury Regulation issued under Section 902 defining "accumulated profits" and asks for deference to it as implementing "the congressional mandate in some reasonable manner," *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979), and as "harmonious with the governing statute" (Gov't Br. 35, citing 440 U.S. at 477). For at least two reasons, no deference is owing. First, the regulation, Treas. Reg. § 1.902-3(c)(1) in the years in issue (Gov't Br. 4a), is confused and confusing, and, second, if taken to say what the

Government seems to urge that it says, it is hopelessly inconsistent with the statute it purports to interpret.

Section 1.902-3(c)(1) says that a foreign corporation's accumulated profits are the sum of its earnings and profits for a year and the foreign taxes "imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable." The confusion arises from the regulation's use in a definition of "accumulated profits" of the phrase "gains, profits, and income," which is itself, by statute, the definitional equivalent of "accumulated profits." The regulation does not undertake to define "gains, profits, and income," although the phrase is used again in the regulation, after its use in the definition of "accumulated profits." *See* Treas. Reg. § 1.902-3(c)(4) (1971 ed.).

The confusion thus engendered is well illustrated by the Claims Court's exegesis of the regulation. The Claims Court, bear in mind, decided for the Government and even thought the regulation supported its decision. (Pet. 26a.) But it said that "[t]his regulation clearly distinguishes 'earnings and profits' from 'gains, profits and income' " and that "[t]he relation of 'gains, profits and income' to foreign income taxes indicates this tax concept is to be equated with foreign taxable income." (Pet. 25a-26a.) The court is quite right, of course, but it could not have realized the implication of what it was saying. For, if what it said is so, then "accumulated profits" too must be equated with "foreign taxable income" because accumulated profits, by statutory definition, are the equivalent of "gains, profits, and income."

What the confusing definition means, with its gratuitous introduction of "earnings and profits" into what would otherwise be a restatement of the statutory definition, is most unclear. But if it is meant to equate earnings and profits and accumulated profits, it is inconsistent with Section 902 for all the reason detailed in Part I of our argument. Those reasons are aptly summed up in the Claims Court's statement that gains, profits and income (and thus, we would add, accumulated profits) are "to be equated with foreign taxable income." In particular, if the regulation's purport is that United States earnings and profits enter into accumulated profits, it ignores the fact that in 1962, just before the regulation was written in 1965, Congress had deliberately declined the opportunity to make Section 902 the twin of the new Section 960 by writing it in terms of earnings and profits. (Pp. 11-12, *supra*.) The regulation is not a reasonable construction that should even begin to command this Court's deference. It is a thoroughgoing reconstruction of the statute. This Court has rejected as unreasonable and inconsistent with the underlying statute far less egregious Treasury interpretations of the Code. *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 26, 30 (1982); *Rowan Cos.* v. *United States*, 452 U.S. 247, 263 (1981); *Northeastern Pennsylvania Nat'l Bank & Trust Co.* v. *United States*, 387 U.S. 213, 218 (1967); *Commissioner* v. *Acker*, 361 U.S. 87, 93-94 (1959).

The Government says that the 1965 regulation "reflects a position first announced by the Treasury more than 55 years ago." (Gov't Br. 35.) Not so. The 1933 pronouncement to which the Government refers did say that accumulated profits must include "all income of the foreign corporation available for distribution to its shareholders, whether such profits be taxable by the foreign country or not." I.T. 2676, XII-1 C.B. 48, 50 (1933), *declared obsolete by* Rev. Rul. 70-293, 1970-1 C.B. 282. It did not say that such all-encompassing income was to be measured by United States tax laws. It did not say that accumulated profits are the equivalent of earnings and profits, as familiar and as meaningful a shorthand phrase in United States tax law in 1933 as it is today. In speaking of a computation that would yield all of a foreign corporation's "distributable income or surplus," I.T. 2676 might very reasonably have been speaking of distributable income as determined under foreign law.[9]

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[9] Whether "accumulated profits" include income that is not taxable by foreign law but by that law is available for distribution to share-

The inconclusive I.T. 2676 was not the first, most nearly contemporaneous, word from the Treasury or the Service on the meaning of "accumulated profits" after it became a part of tax law in 1921. Until 1933 the Treasury Department forms that a taxpayer filed to claim the deemed-paid tax credit clearly directed that the taxpayer use foreign taxable income as the denominator in the proration formula, first under Section 240(c) of the Revenue Act of 1918 as the "total taxable income" of that statute, and then, more significantly, as the equivalent of the "accumulated profits" of Section 238(e) of the Revenue Act of 1921. *See* Gallagher, *A Will-o'-the-Wisp in the Indirect Foreign Tax Credit: The Term "Accumulated Profits"*, 12 Tax Executive, 291, 306-08 (1960). After 1933 these forms accorded with the ambiguous I.T. 2676, still not specifying the use of United States tax law to define accumulated profits.

A 1963 ruling (Gov't Br. 33-34) did state that "the criteria applicable to the determination of 'earnings and profits' are equally applicable to the determination of 'accumulated profits.' " Rev. Rul. 63-6, 1963-1 C.B. 126, 128. But that ruling, which a careful contemporaneous reader said did not equate earnings and profits and accumulated profits,[10] was declared to be obsolete by Rev. Rul. 72-621, 1972-2 C.B. 651, whether because of the promulgation of the superseding 1965 regulation or for some other reason. The 1965 regulation is the only present authority. Not surprisingly, administrative rulings since 1965 have parroted or cited it (Gov't Br. 34) even as they have striven to reconcile the equation of "earnings and profits" and "accumulated profits" with the policy of avoiding double taxation. *E.g.*, Rev. Rul. 74-310, 1974-2 C.B. 205; Rev.

holders—something comparable to our municipal bond interest—is not an issue in this case. It is by no means a recurrent issue and, given the 1986 amendment of Section 902 (Gov't Br. 39 n.17), it is an issue that this Court very likely will never have to confront.

[10] *See* Schoenfeld, *Some Definitional Problems in the Deemed Paid Foreign Tax Credit of Section 902: "Dividends" and "Accumulated Profits"*, 18 Tax L. Rev. 401, 418-19 (1963).

Rul. 71-65, 1971-1 C.B. 212; G.C.M. 36814 (Aug. 18, 1976) (LEXIS, Fedtax library, Rels file). Those rulings in any event add no weight to the authority of the regulation. The Government's case for deference to an agency interpretation stands or falls with the tortured regulation.

The issue that the Federal Circuit decided in this case was an issue of first impression for federal courts, including the Tax Court. In some cases where the issue has differed from what it is here, there are dicta that quote or cite the Treasury's regulation. In the one case on which the Government relies that preceded the regulation, *Steel Improvement & Forge Co.* v. *Commissioner*, 36 T.C. 265, 277 (1961), *rev'd*, 314 F.2d 96 (6th Cir. 1963), it is clear from the entirety of a passage that the Government quotes in part (Gov't Br. 37 n. 15) that the court was saying something wholly noncontroversial and not something that supports the Government's argument here. The court said that, "*in determining the character of the dividends received by residents of the United States from foreign corporations*, the accumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law." (Italicized words omitted from Government's brief.) That is a proposition with which no one quarrels.

The views of commentators on the issue (*see* Gov't Br. 38 n.16) have varied.[11] Whatever has gone before, it is now clear, on the sustained textual and policy analysis that this case by posing the issue squarely has demanded, that only the measurement of accumulated profits by foreign-law standards fits the text of the statute as the text is illuminated by context and history; it is now clear that only the measurement of accumulated profits by foreign-law standards enables the statute to serve its bedrock purpose of matching foreign profits, taxes, and dividends in such a way as to ensure to the United States corporate

[11] Compare two extended treatments: *Gallagher, supra* ("accumulated profits should be equated to foreign taxable income," 12 Tax Executive at 328), *with* Schoenfeld, *supra* note 10 at 407-21 (unspecified "American concepts must be used in defining" the term, *id.* at 420).

taxpayer a credit fairly proportionate to the dividend it receives and the foreign tax paid in respect of it.

CONCLUSION

The judgment of the Court of Appeals for the Federal Circuit should be affirmed.

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